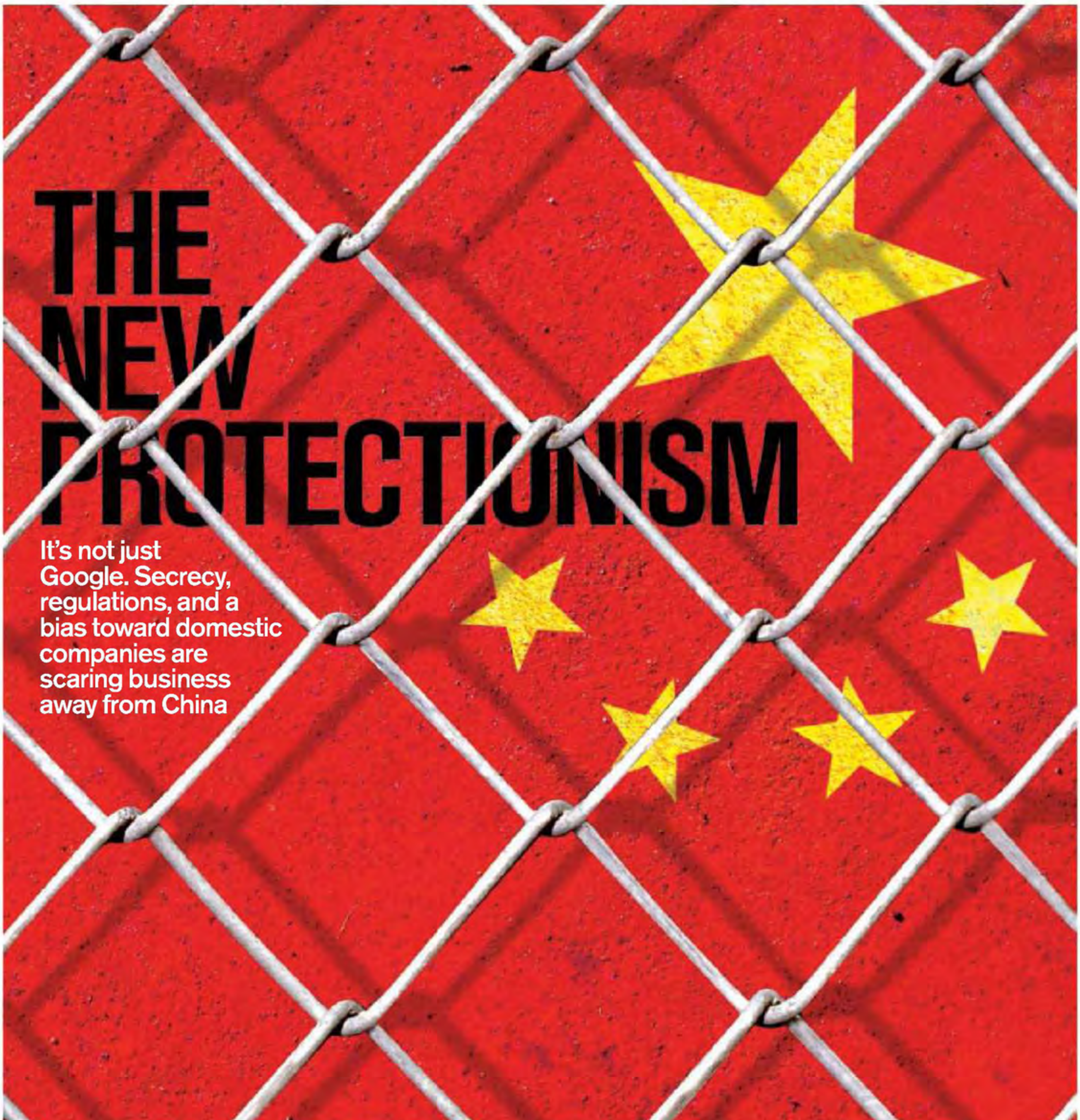
APRIL 5, 2010 | BUSINESSWEEK.COM

COMP SPECIAL: CEOs & COACHES | EDDIE LAMPERT: SEARS SUCKER?

Bloomberg BusinessWeek



THE NEW PROTECTIONISM

It's not just Google. Secrecy, regulations, and a bias toward domestic companies are scaring business away from China


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Western companies are getting a frosty reception on the mainland and facing new trade, patent, and procurement policies that shut them out as Beijing promotes homegrown rivals.
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When he merged Kmart and Sears five years ago, the hedge fund guru was hailed as the next Buffett. But steadily declining same-store sales, plus a downturn, have made Sears Holdings a chronic underperformer.

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Bloomberg BusinessWeek looked into the 2009 pay of CEOs at 81 big companies. A shift away from stock options and awards means bosses' fortunes are less aligned with those of their companies.

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No one makes more money from the annual NCAA basketball tourney than the top coaches. Are they worth all those millions?



U.S. trade groups recently warned the White House of "systemic" favoritism in China

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BusinessWeek The Global Report



Aetna CEO Williams on health coverage

The Week in Business

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(TOP TO BOTTOM) LYNN GOLDSMITH/CORBIS; SEYMORE CHWAST; BEN BAKER/REDUX



GE Capital helped keep Esmark Steel in the family.

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Edited by
Harry Maurer and
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THE WEEK IN BUSINESS



Pelosi after the health-care vote: Her skill was critical in pushing the bill through

THE WASHINGTON POST/GETTY IMAGES

ECONOMICS & POLICY

OBAMA'S HEALTH-CARE WIN

It took a roller-coaster 14 months, every ounce of political capital at **President Barack Obama's** disposal, and a critical push from **House Speaker Nancy Pelosi,** but the health-care reform bill finally became law on Mar. 23 after the House passed it two days earlier by the thin margin of 219-212. Skirmishing now returns to the Senate, which is expected to approve, over bitter Republican opposition, a package of changes to the original Senate bill that the House adopted. GOP leaders predict that Democrats will pay a painful price in this year's midterm elections, but the political fallout from the most important piece of social legislation in more than three decades is far from clear. Some of the bill's most popular provisions—among them, barring insurance companies from dumping customers after they become sick and letting children stay on their parents' plans until age 26—will take effect soon, while more controversial elements will phase in slowly. Obama's win could also give his Administration impetus in grappling with other long-intractable issues, including immigration and Social Security reform.

| BW | PAGE 64 "Obamacare's Cost Scalpel"

NEXT: FINANCIAL REFORM

Once the health-care battle ends, Congress will take up the cudgels over financial regulation. The **Senate Banking Committee** on Mar. 22 reported out a bill on a straight party-line vote. It would create a **Consumer Financial Protection Bureau** within the **Fed,** regulate some derivatives trading, and give the government more authority to seize firms whose failure could threaten the system. Liberal critics derided the legislation as fatally watered down by bank lobbyists, while Republicans expressed alarm that regulators would be handed too much power. Leaders of both parties, however, held out hopes that a

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† Jim Cramer, *Getting Back to Even* (Simon & Schuster).

EXECUTIVE SUMMARY

deal could be struck that would avoid another partisan dogfight.

TECHNOLOGY

GOOGLE PULLS THE PLUG

On Mar. 22 the search king began directing users of its Chinese-language search engine, Google.cn, to an alternative page run from Hong Kong, outside the jurisdiction of China's strict censorship laws. The move, which comes two months after Google said cyber attacks against its computers had caused it to rethink its position in China, effectively ends a four-year effort to operate a search engine on the mainland. Soon after the closure of Google.cn, Chinese officials called the company's actions "totally wrong," according to the official Xinhua news agency, and Google's partners in China were expected to cancel alliances.

Meanwhile, in another closely watched China matter, four executives of mining giant **Rio Tinto** pleaded guilty on Mar. 22 to accepting bribes from Chinese steelmakers. The pleas came as a surprise, since the executives had been accused of a different offense: trying to obtain secret information about the steel industry. A judge is expected to rule within weeks on the confessions and the commercial spying charges.

| BW | PAGE 32 "Closing for Business?"

"With Google Gone, Baidu Rules China"
businessweek.com/magazine



A Chinese foundry: Did steel companies bribe Rio Tinto executives?

JIANAN YU/REUTERS

STRATEGY

A GIANT OFFERING

It's the world's biggest IPO in two years and Japan's largest in a decade. **Dai-ichi Mutual Life Insurance** will raise $11 billion in an offering that was priced on Mar. 23 in the middle of its forecast range. Prior to Dai-ichi's move, Japanese companies had raised $490 million in six IPOs this year, compared with 15 U.S. deals totaling almost $3 billion, according to Bloomberg data. Last year was the worst in two decades for Japanese IPOs. The previous largest public offering in Japan was **NTT DoCoMo's** listing in 1998. San Francisco-based **Visa** raised $19.7 billion in 2008.

"Dai-ichi Raises $11 billion in World's Biggest IPO of 2010"
businessweek.com/magazine

FROWNING ON TOYOTA

In the wake of extensive recalls of cars subject to unintended acceleration, Toyota's reputation in the U.S. is badly dented, according to a **Bloomberg National Survey.** Just 49% of 1,002 adults in the Mar. 19-22 poll rated the carmaker as "favorable," and 44% said they definitely wouldn't buy a Toyota within the

THE OPTIMISM METER

THE JOB OUTLOOK IMPROVES SLIGHTLY



The Meter clocked in at 54 on Mar. 23, up from 45 one month earlier, as the U.S. employment picture continued to improve. The average estimated unemployment rate for 2010 is now 9.6%, down from 9.8% in late February, according to a Bloomberg survey of economists. Developed by ***Bloomberg BusinessWeek*** using data from pollster **YouGov,** the Meter is a proprietary measure of sentiment and expectations, economic statistics, and market forecasts. It evaluates shifts in outlook among individuals, professional investors, and economists in the areas of U.S. economic growth, jobs, equity markets, and real estate.

Calculated using consumer polling, economic forecasts, and financial markets data; 0=lowest and 100=highest

Data: YouGov, *Bloomberg BusinessWeek*

$17.9 million

Amount Ford Chief Executive Alan Mulally received in compensation in 2009, when the automaker posted its first profit in four years

Data: Company filings



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EXECUTIVE SUMMARY

next year. **Ford** earned the highest favorable rating, at 77%, with Toyota ranking fifth behind Ford, **Honda, General Motors,** and **Nissan.** Toyota is using no-interest loans and lease discounts to coax back buyers after recalls of 8 million vehicles cut sales by 12% in the first two months of this year.

FINANCE

ARRESTS IN BRITAIN

As part of its largest-ever probe into insider trading, Britain's **Financial Services Authority** arrested seven people on Mar. 22 and 23, including a trader at hedge fund **Moore Capital** and bankers at **Deutsche Bank** and **Exane,** half-owned by **BNP Paribas.** The FSA, under pressure to take more action against insider trading, said the investigation dates to 2007.

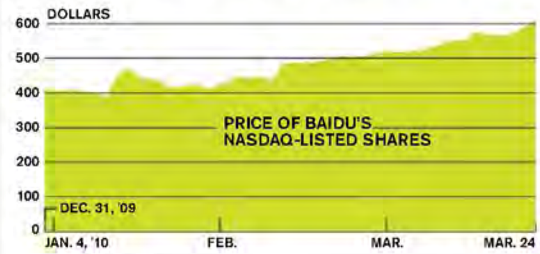
LEADERSHIP

HAROLD McGRAW JR. DIES

On Mar. 24, **Harold W. McGraw Jr.,** former chairman and CEO of McGraw-Hill Inc., died at the age of 92. In 1947, McGraw joined the publishing company founded in 1909 by his grandfather, **James,** and became president of its book division in 1968. The unit grew rapidly during his tenure, becoming the top U.S. textbook publisher. In 1978, McGraw was named president of the parent company, now known as **The McGraw-Hill Companies.** In 1979 he fought off a hostile takeover offer from **American Express,** and in 1980 McGraw-Hill passed $1 billion in annual revenues. The company began publishing *Business Week* in 1929 and sold it to **Bloomberg** in 2009. McGraw's son **Harold W. McGraw III** is now CEO. McGraw was an uncommon man with a common touch—and a sense of humor. A few years ago at the annual Christmas gathering of employees who worked at McGraw-Hill for 25 years or more, he greeted them and then said with a smile as he leaned on his cane: "You all look like hell."

GOOGLE'S LOSS, BAIDU'S WIN

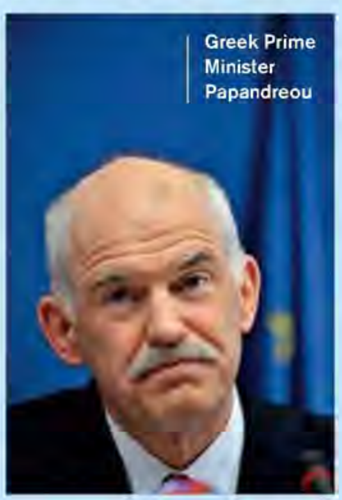
The stock of the Chinese Internet search company has shot up more than 50% in recent months



Data: Bloomberg

IDEAS IS GREECE ALREADY DOOMED TO DEFAULT?

The suspenseful Greek drama seems well into its fifth act. In an unexpected twist, **German Chancellor Angela Merkel** on Mar. 21 reversed herself and said the Continent's biggest economy opposes a **European Union**-funded rescue for Athens, which must refinance $27 billion in debt before the summer. As EU policymakers head for a two-day summit starting on Mar. 25, Merkel warned that the meeting may not produce an aid agreement.



Greek Prime Minister Papandreou

Some economists, however, think the dénouement of this play has already been written. In a Mar. 11 post on *The New York Times* **Economix** blog, **Simon Johnson** of MIT and **Peter Boone** of the London School of Economics argued that Greece's debt load is probably unsustainable. Their line of reasoning: Assume that the interest rate Athens must pay on new bond issues rises to 10%—a modest premium, say the writers, for a country with the highest external debt-to-GDP ratio in the world. If Greece were to roll over its existing stock of debt at such rates, it would end up transferring the equivalent of 12% of GDP abroad each year. To put that figure in context, consider that German reparation payments in the aftermath of World War I totaled some 2.4% of GDP. And in the wake of the Latin American debt crisis of the 1980s, net transfers abroad equaled 3.5% of GDP. "Seen in this comparative perspective, Greece is still going bankrupt unless it gets a great deal more European assistance or puts a more drastic austerity program in place. Probably it needs both," wrote Johnson and Boone.

As if to ratchet up the tension, **Fitch Ratings** on Mar. 24 downgraded the public debt of another deep-in-hock nation: Portugal. The move drove the euro to a 10-month low against the dollar.

ERIC HERCHAFT/REPORTERS/REDUX

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AT THE TABLE CHARLIE ROSE





(TOP) BRAD TRENT; MICHAEL LEWIS

AETNA'S RON WILLIAMS
Health Care: What to Expect

Nixon couldn't do it. Clinton couldn't do it. But on Mar. 23, after decades of debate, lobbying, and political wrangling, Barack Obama signed health reform into law. What does this new mandate mean for individuals, companies, and the health-care industry? On Mar. 24, I talked with one of the executives on the firing line, Chairman and CEO Ron Williams of Aetna, which provides health-insurance benefits to more than 36 million Americans.

CHARLIE ROSE

How do you assess the health-reform bill just signed by President Obama?

RONALD A. WILLIAMS

I think it is a significant milestone because it will give millions of people access to health-care services. I would probably have done things a little differently. But this is now an opportunity to get to work on the fundamental affordability of health-care services, [because] the mischaracterization of our industry as the problem really didn't permit us to work in a collaborative way.

My impression is that the President listened to doctors, nurses, insurance companies, and every other element of the health-care community.

There was good dialogue, but for a variety of reasons there was a point in the dialogue—in the summer—when the focus shifted from health-care reform to health-insurance reform. But it's not too late. We're committed to looking beyond where we are now and getting back to what we need to do to really achieve affordability.

Will insurance premiums go up?
The answer is yes, and some of the things that will drive those premiums are significant additional taxes the industry will ultimately have to pay in the first year.

The President said that this bill would not have any impact on people who already had coverage, that it was about the uninsured, that there would be no change. Will this legislation change the coverage of people who are already paying for it?
My perception is, yes, things will change. You might not have a plan that includes the exact same doctors. You might have plans that have richer benefits, and therefore you're going to pay more for benefits you may or may not want. It would have been a better message to say, we're going to make certain you maintain your eligibility.

Clay Christensen of Harvard Business School said recently that in health care, competition does not help control costs but rather drives them up. He said the structure of the system pits hospitals that want to fill their beds against insurers that want to minimize reimbursement and access. His answer was the health-care provider and health-care insurer should be one and the same, suggesting an integrated system like Kaiser Permanente in California.
Well, I think it's an interesting idea. But all health care, ultimately, is local. There are communities where that model has worked well. Kaiser and Group Health of Puget Sound are examples of where that's worked very well. But it requires a unique physician culture. And even firms like Kaiser, which has tried to expand into other geographies, have found that it's incredibly hard to replicate. Where it can work, it's a fine model. It's just not going to work in most communities.



Protestors at the Capitol on the day before the House passed the bill

During this year of debate that you talked about, there was a moment in which Health & Human Services Secretary Kathleen Sebelius was concerned by Anthem Blue Cross in California proposing a 39% rate hike and wanted an answer from the insurance company and the industry as to why this was happening? Was it justifiable, especially at a time of recession? What was the answer?
I'll leave it to others to explain the exact increase, because it wasn't our firm that was doing it, but the generic answer I gave the Secretary was first you had an increase from the underlying rate of medical costs—inflation from hospitals, physicians, drugs, devices, technology. You then had the fact that as a result of the economy, healthy members who had been insured for some time but found themselves in tight economic circumstances were canceling their insurance. So you lose the subsidy that is keeping the premium affordable for the insurance pool. At the same time you had a third factor: Healthy young members, as a result of the economy, not entering the insurance pool. Finally there is simply the aging of the population in the insurance pool. And I think that to blame the premium on the health plan really doesn't get at the underlying forces.

OUR 35,000 EMPLOYEES AT AETNA WERE PERPLEXED AND...VERY DISAPPOINTED IN THE LEADERSHIP OF THE COUNTRY

Do you feel like the insurance industry was demonized in this debate that took place over the last year?
Yes, I do. And I think our 35,000 employees at Aetna were perplexed and really, I think, very disappointed in the leadership of the country and their selection to demonize and impugn the motives of employees, doctors, nurses, and pharmacists.

By that, you mean the President.
I mean everyone involved.

A *Wall Street Journal* editorial on Mar. 22 said the first result of reform will be turmoil in the insurance industry, and as small insurers find it impossible to make money, a wave of consolidation is likely. You've already said premiums are going to go up. Are we also going to see consolidation?
I'm much more worried about the solvency question. If you're a small plan and you experience costs that you simply weren't able to price for, there could very well be insolvencies. It's been a long time since we've seen them in the insurance industry, but the insurance commissioners know what can happen. |BW|

Watch Charlie Rose on Bloomberg TV weeknights at 8 p.m. and 10 p.m.

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THOSE WHO INVESTED
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BUSINESS OUTLOOK | KATHLEEN M. HOWLEY AND RICH MILLER

AS THE FED PULLS BACK, CAN HOUSING STAND ALONE?

Home sales just fell again. With the central bank about to stop buying mortgage securities and the housing tax credit expiring, questions abound over housing's future

For months, investors' favorite parlor game has been betting on the timing—and the impact—of the Federal Reserve's decision to raise its benchmark interest rate from its current near-zero level. But there's a key sector of the economy where a Fed return to normalcy is set to play out much sooner: housing.

Sales of both existing and new homes fell in February for the third and fourth straight months, respectively. Yet at the end of March the central bank will withdraw a big support under the housing market when it ends its $1.4 trillion program to purchase mortgage-backed securities and housing-agency debt. A month later the federal home-buyer tax credit expires. Some housing watchers fret that one-two punch could send the sector back to the mat.

2.1 million

The number of vacant homes for sale in the fourth quarter of 2009

Data: U.S. Census Bureau

A growing number of economists, however, believe that a pickup in employment this spring, cheap credit, and a glut of affordable homes will allow housing not only to withstand the removal of government help in 2010 but also to contribute to U.S. annual economic growth for the first time since 2006.

Employment is key to this outlook. Morgan Stanley economist David Greenlaw forecasts as many as 300,000 new U.S. jobs in March, the biggest monthly increase in four years, because of milder weather, government hiring of temporary workers for the U.S. Census, and a growing economy.

Credit conditions also may be improving. A net 13.2% of banks surveyed by the Fed in January reported that they tightened lending standards on prime mortgages in the fourth quarter. That's the smallest percentage in three years.

Meanwhile, falling prices and low mortgage rates have made homes more affordable. The median price of a U.S. home was $165,100 in February, the second-lowest reading since May 2002. And the average rate for a 30-year fixed mortgage was 4.96% in mid-March, not far above December's record-low 4.71%.

The result of that potent mix of less-expensive homes and cheap credit: The average U.S. household had 177.8% of the income needed to purchase a property in January, the highest since last April's 184%, the record.

That's behind some forecasters' optimism. David Crowe, chief economist at the National Association of Home Builders (NAHB), says sales of new homes will likely total 459,000 in 2010, up from 372,000 last year. And Barclays Capital economist Dean Maki, who figures overall home sales will rise about 6% this year, says housing will account for 0.25 percentage points of the 3.6% growth he foresees for the U.S. economy.

The first test of that scenario comes later this month when the Fed ends its program to purchase $1.25 trillion of mortgage-backed securities and about $175 billion of housing-agency debt.

Credit Suisse mortgage strategist Mahesh Swaminathan says private demand for mortgage debt is now strong enough to replace that of the central bank. And Barclays Capital Managing Director Ajay Rajadhyaksha says the spread between the yields on mortgage-backed securities and Treasury notes should widen only slightly this quarter, signaling that the risk premium on mortgage debt won't spike after the Fed withdrawal.

Likewise, the impact of the expiration of the home-buyer credit should be minimal. The original credit for first-time buyers helped boost existing-home sales by 4.9%, to 5.16 million, in 2009, the first rise since 2005. The credit, slated to end last Nov. 30, was expanded to include some trade-up buyers and extended through April. But the extension hasn't helped much: The credit of up to $8,000 will result in only 180,000 extra sales from December to April, says the NAHB's Crowe.

Another challenge in 2010: the supply of properties for sale could rise even further. Foreclosures may increase to 2.2 million this year from 2009's record 1.7 million, predicts Mark Zandi, chief economist at Moody's Economy.com. But Thomas Lawler, a former Fannie Mae economist, says an improving job market would spur household formation and help absorb the excess supply. While that doesn't portend a robust rebound, it suggests the worst may be over for housing. BW

HOMES HAVE BECOME MUCH MORE AFFORDABLE



Data: National Association of Realtors, Bloomberg

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30 Commentary: Al Hunt on Obama's legacy

Cold Case: Lessons From The Lehman Autopsy

The SEC can learn from Anton Valukas, the Chicago attorney who led a probe into Lehman—and uncovered accounting chicanery that regulators largely ignored

COMMENTARY

By Paul M. Barrett

In 2008, Anton R. Valukas, a trial attorney in Chicago, published a four-page stiletto thrust of an essay entitled, "Arrogance: My Favorite Sin." The piece, included in a lawyers' guide to cross-examination, recounted Valukas' delight in using understated questioning to tempt executives into making implausible statements of the sort that reliably alienate jurors. "Frequently, the smartest witnesses—the most sophisticated and the most arrogant—are most susceptible to this type of examination," he wrote.

The piece reads today like a preamble to Valukas' voluminous autopsy of Lehman Brothers, which he performed as the court-approved bankruptcy examiner in the investment bank's formal unwinding. The 2,200-page Lehman report, released on Mar. 11, constitutes the single most penetrating document we have on the recent misbehavior on Wall Street. Valukas' earlier primer suggests why he did such an exemplary job: Although he heads a prestigious corporate law firm, Jenner & Block, the former federal prosecutor just plain resents dissembling by big shots in expensive suits. Not coincidentally, Jenner, a pillar of the Chicago business elite, sues Wall Street institutions as often as it defends them.

In the interest of preventing future Lehman disasters, we might ponder how to transplant Valukas' zeal into Washington's financial beat cops. That could help preclude the need to call him back again as corporate pathologist.

He'd be a hard man to clone. During a four-decade career, Valukas, 66, has represented all manner of white-collar rogues. When called to public service, he used his knowledge of the market's shadowy corners to prosecute well-heeled miscreants. In the late 1980s, as U.S. Attorney in Chicago, he sent agents disguised as commodity traders to clean up the futures exchanges. The probe protected investors and led to a slew of indictments. Some called him the Rudy Giuliani of the Midwest.

Unlike Giuliani, Valukas avoided elective politics and returned to his law firm. He prospered at Jenner, not least in his yearlong assignment as the Lehman examiner. Backed by colleagues from Jenner, he went over millions of pages of documents, interviewed scores of witnesses, and billed the Lehman estate $38.4 million. I'd say it was money well spent. His findings will provide the script for what's likely to be a theatrical airing in April, when Representative Barney Frank (D-Mass.) convenes his House Financial Services Committee to interrogate Lehman's former CEO, Richard S. Fuld Jr., and other participants in the debacle.

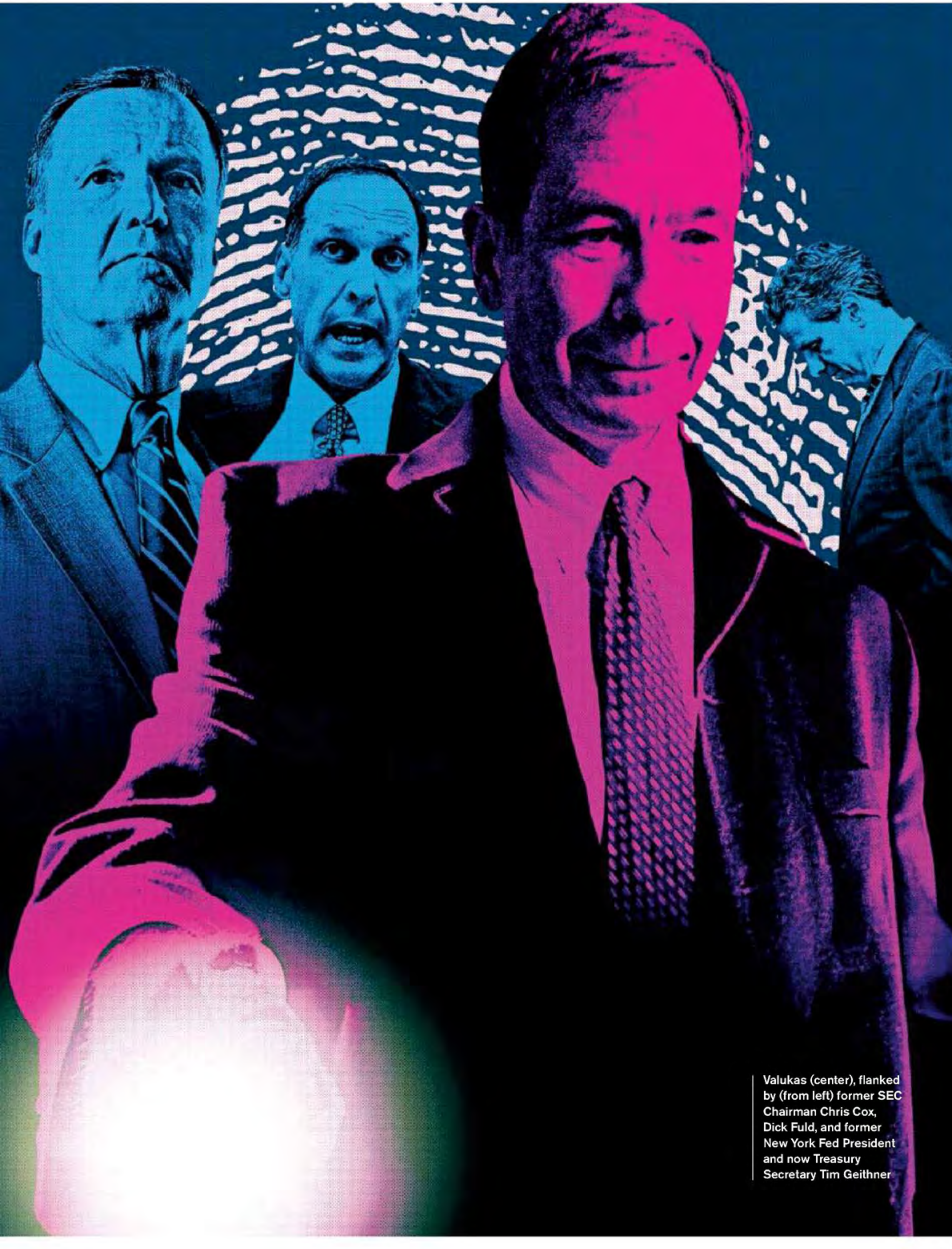
DUBIOUS BEHAVIOR

What Valukas brought to the endeavor was a no-nonsense lack of deference toward Wall Street game playing, says Francine McKenna, a former managing director at PricewaterhouseCoopers. "That's a Chicago thing," adds McKenna, herself a resident of the city. She now runs an investigative Web site called Re: The Auditors. "The mindset is: I've been around the block, I know how the game is played, and I'm not impressed by fancy names," she says.

As the Lehman examiner, Valukas doggedly unmasked the dubious behavior of executives once lauded as among Wall Street's conquering



PHOTO ILLUSTRATION BY SEAN McCABE (L TO R) PHOTOGRAPHS BY JAY MALLIN/ZUMA; SUSAN WALSH/AP; FRANK POLICH/BLOOMBERG; HARAZ N. GHANBARI/AP



Valukas (center), flanked by (from left) former SEC Chairman Chris Cox, Dick Fuld, and former New York Fed President and now Treasury Secretary Tim Geithner

heroes. Fuld insisted to Valukas that he knew nothing about the accounting trickery called Repo 105, which was used to hide the bank's financial decline. Fuld's self-portrait—a veteran CEO blithely unfamiliar with the workings of his company—was not just implausible; it could support lucrative civil claims that he "was at least grossly negligent," as Valukas wrote. The examiner noted that Fuld's denials were undercut by evidence that he was thoroughly briefed on the chicanery.

Contacted by phone, Valukas declined to comment. Fuld's attorney, Patricia Hynes, has said her client told the truth and did nothing wrong.

There will be time enough to sort out legal culpability for Lehman's demise. The Justice Dept. is investigating, and civil litigation is under way. Valukas lays out facts without playing judge or jury. "There are many reasons Lehman failed," he noted, "and the responsibility is shared."

Beyond the bank itself, Valukas pointed to evidence that Lehman's auditor, Ernst & Young, committed malpractice when it sat on a whistleblower's warnings and failed to keep the bank's board apprised of suspicious executive conduct. Ernst has denied any professional failings or liability.

The regulators also bear blame in Valukas' account. Some of the most unnerving portions of his report explain that while Lehman failed to keep investors informed, staff members from the Securities & Exchange Commission and Federal Reserve Bank of New York did know what was going on—and shrugged their shoulders.

PUBLIC-SPIRITED PIT BULL

Government overseers, some of whom worked on site in Lehman's offices in 2008, had access to the bank's pertinent records. Former Lehmanites told Valukas that the government didn't raise significant objections or direct Lehman to take corrective action. SEC spokesman John Nester said in an interview with Bloomberg News: "We are looking closely at the examiner's findings as part of our ongoing review of the accounting and disclosures of major financial institutions and their role in the financial crisis." This is the same agency, of course, that yawned at warnings about Bernard Madoff's globe-spanning Ponzi racket.

"The unavoidable question is whether the SEC will hold someone responsible for what happened at Lehman," says Michael J. Missal, a partner in Washington with the law firm K&L Gates. Missal, who makes a living defending companies faced with



"THERE ARE MANY REASONS LEHMAN FAILED, AND THE RESPONSIBILITY IS SHARED," VALUKAS WROTE

government investigations, is another of those attorneys capable, when asked by a court, of transforming himself into a public-spirited, if generously compensated, pit bull. He published an impressive bankruptcy examiner's report of his own in 2008 in the case of New Century Financial, one of the subprime mortgage giants that, with Wall Street's assistance, recklessly inflated the housing bubble.

So, how do we energize the regulatory ranks with the punch that a Valukas or Missal brings to this kind of work? One fantasy would be to replace wholesale the SEC's Enforcement Division with lawyers drawn from the staffs of past high-level bankruptcy examiners. In addition to the Lehman and New Century cases, solid investigative work was done in the wake of Enron's collapse in 2001 and the 2005 implosion of Refco, a large brokerage.

The obstacles to creating a regulatory Delta Force are familiar ones: pay and prestige. "The law firms offer money and status," says Max Stier, president of the nonprofit Partnership for Public Service. "Even when good people come into government service, many soon leave through the revolving door." Stier's Washington group runs programs to enrich government careers and encourage corporate employees to try public service. He has held legal jobs in all three branches and practiced with a Washington law firm. Stier acknowledges that government salaries will never compete with private-sector compensation. He observes that at many key agencies, the revolving door has spun all the more swiftly for the past generation as a bipartisan consensus celebrated the notion that the financial markets effectively police themselves and regulators should get out of the way. If we didn't know already, the Valukas report reminds us once and for all to drop that delusion. Done right, regulation promotes capitalism by deterring excess and fraud. "Political leaders need to prioritize talent at agencies like the SEC, which historically hasn't happened," says Stier.

One intriguing suggestion for how to put Stier's advice into action comes from Scott McCleskey, a former vice-president for compliance at Moody's Investors Service. In a Mar. 20 op-ed in *The New York Times*, McCleskey, who now works for Complinet, a compliance-consulting firm, proposed the creation for financial regulators of an analog to the U.S. Foreign Service. Too many SEC staff members are inexperienced attorneys; the best ones tend to depart after a few years for private practice. McCleskey argued that the Foreign Service model—with its specialized training; attractive pension eligibility after as little as 20 years on the job; and long-term career tracks, allowing for variety and new challenges—would draw more impressive applicants and cut down on turnover.

Perhaps President Barack Obama could persuade Valukas to take a sabbatical and serve as the first dean of a new Federal College of Financial Regulators. It wouldn't hurt to ask. |BW|

PHOTO ILLUSTRATION BY SEAN McCABE

Smarter business for a Smarter Planet:

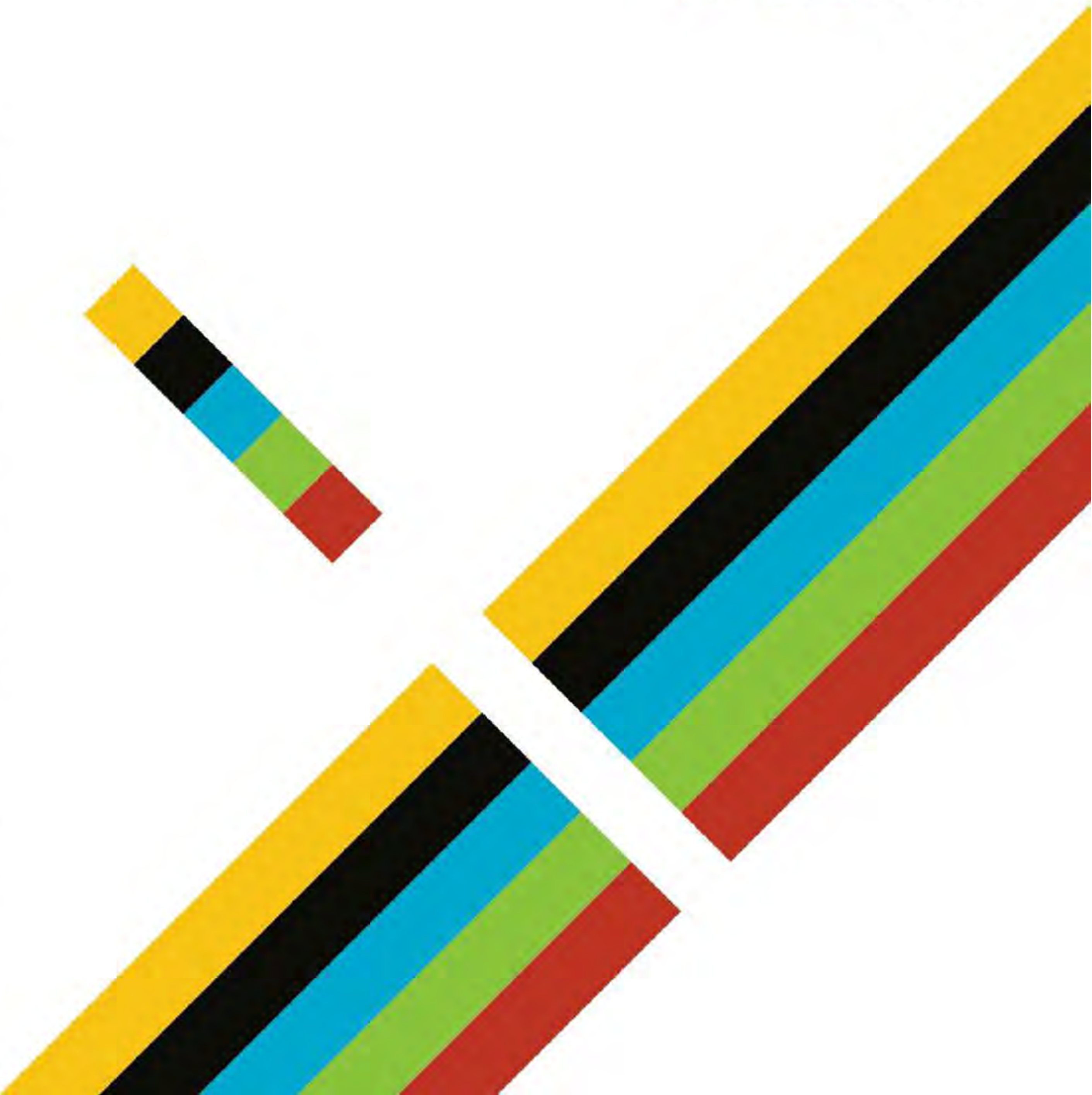
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The renovated Miami Beach hotel opened amid the recession

A Double Flop for The Fontainebleau

Jeffrey Soffer's plans to create lavish resorts have come to grief in Las Vegas and are troubled in Miami

By Beth Jinks and Jonathan Keehner

Like many of the men who built South Florida, Donald Soffer is a transplant, a native of Pennsylvania steel country who began making his fortune putting up shopping centers in and around Pittsburgh. Turning to Miami in the late '60s he plunked down more malls and branched into condo towers and planned communities. His son Jeffrey helped steer Turnberry Associates, the family business, toward more upscale projects—then overreached. In 2005, Jeffrey formed Fontainebleau Resorts and spent $3 billion of mostly borrowed money renovating the iconic Fontainebleau hotel in Miami Beach and starting work on a lavish casino resort in Las Vegas.

His timing could hardly have been worse. The unfinished Vegas project has already been lost to bankruptcy—billionaire investor Carl Icahn scavenged it in February—and Jeffrey Soffer is now fending off lawsuits and scrambling to hold on to the Miami resort.

"Soffer made a big bet on the Fontainebleau that went very wrong, twice," says Dan Fasulo, managing director of New York research firm Real Capital Analytics. "It's a mess."

"Very few people foresaw the depth of the economic and lending crisis of the past few years," says Jeffrey Soffer, 42, in his only comment for this article. "I regret that we didn't see Fontainebleau Las Vegas to fruition but remain proud of our efforts there and in Miami."

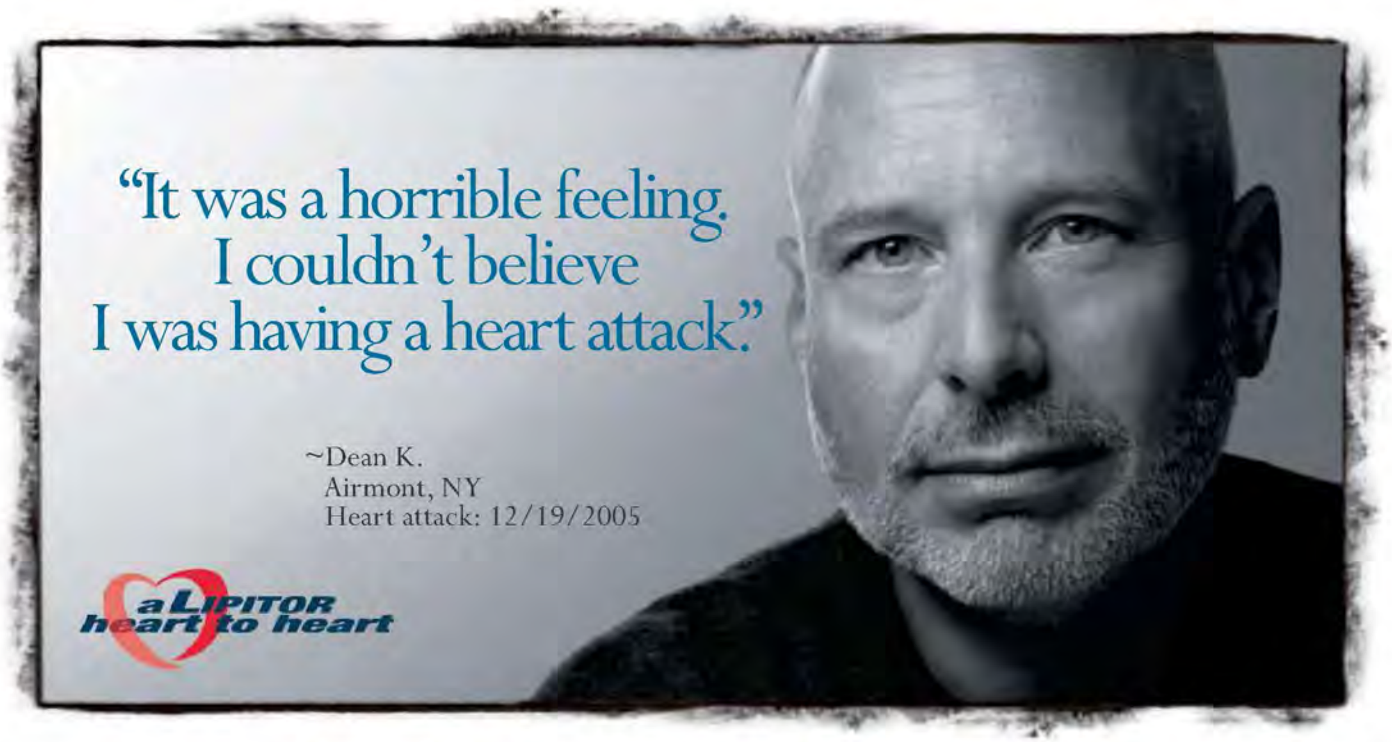

Jeffrey Soffer

Fontainebleau Miami Beach hasn't made loan payments since September after borrowing more than $620 million to redevelop the property. On Mar. 17, Soffer and his partner in the venture, Mideast investment group Dubai World, offered to put up an additional $100 million as part of a restructuring plan. Bank of America and other lenders are now weighing the proposal. Dubai World and BofA declined to comment.

The projects have led to a welter of claims from creditors and contractors against Fontainebleau Resorts, various affiliates of Turnberry, and Jeffrey Soffer himself. Bankrupt Lehman Brothers is suing Soffer over $400 million in personal guarantees he made on loans to build the retail portion of Fontainebleau Las Vegas. Soffer has said that Lehman's claims are not valid.

The Fontainebleau troubles mark a major reversal for the Soffer family, whose Turnberry Associates has developed more than

(FROM TOP) FONTAINEBLEAU MIAMI BEACH; LYNNE SLADKY/AP



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- Allergic reactions including swelling of the face, lips, tongue, and/or throat that may cause difficulty in breathing or swallowing which may require treatment right away
- Nausea, vomiting, or stomach pain
- Brown or dark-colored urine
- Feeling more tired than usual
- Your skin and the whites of your eyes turn yellow
- Allergic skin reactions

Common side effects of LIPITOR are:

- Diarrhea
- Upset stomach
- Muscle and joint pain
- Changes in some blood tests

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Soffer spent $2 billion on the unfinished Las Vegas casino resort

RONDA CHURCHILL/BLOOMBERG

$7 billion in commercial and residential property since Donald Soffer, 77, founded the firm more than 50 years ago. Delving into Florida real estate in 1967, Donald transformed 785 mosquito-infested acres along the Intracoastal Waterway in north Dade County into Aventura, a planned city bordering Miami that now encompasses the Turnberry Isle Resort & Club and Aventura Mall, Turnberry's 2.8 million-square-foot shopping center.

Jeffrey Soffer joined his father's firm in 1987, not long after graduating from high school; he did not get a college degree. A fixture on the Miami social scene, Jeffrey, who is divorced, is often photographed with model Elle Macpherson and has a taste for expensive toys. He races Ferraris and has a pilot's license. *Madsummer*, his 257-foot yacht, features a spa, movie theater, and a helicopter pad. *Madsummer* is now listed for sale.

Jeffrey helped shift Turnberry's focus from suburban malls and planned communities to lavish Miami and Las Vegas resorts and condominiums, riding the real estate mania in what would become two of the nation's most overheated markets. Soffer's early efforts in Las Vegas were successful: Turnberry Place, a complex of four 38-story condo towers off the Las Vegas Strip, and three condo-hotel towers at MGM Grand casino, a joint venture with MGM Mirage, sold out.

But Soffer's winning streak didn't last. In 2005 he oversaw Turnberry's acquisition of the grand but aged Fontainebleau Miami, a local landmark opened in 1954, which he viewed as the foundation of a resort brand that could be marketed around the world. Teaming up with Glenn Schaeffer, former president of Mandalay Resort Group, he formed Fontainebleau Resorts to renovate the hotel and develop 27 acres on the Las Vegas Strip with a 100,000-square-foot casino, 4,000 luxury hotel rooms, and 3,300-seat theater. Plans called for spending $500 million on the Miami renovation and $2.9 billion in Las Vegas.

As costs mounted—the final bill for Miami Beach was $1 billion—Soffer sought partners to share the burden. Australian billionaire James Packer paid $250 million in 2007 to acquire a 20% stake in Fontainebleau Resorts. Packer declined to comment. Nakheel, the development arm of Dubai World, ponied up $375 million for half the Fontainebleau Miami in 2008.

SOFFER VIEWED FONTAINEBLEAU AS A LUXURY BRAND THAT HE COULD MARKET AROUND THE WORLD

"THE WRONG TIME"

Then the economy turned. In 2008, Las Vegas suffered a devastating slump in which property values, room rates, and gambling revenues fell sharply. In November of that year, when the Fontainebleau Miami reopened—advertising an oceanfront "poolscape" where James Bond and Goldfinger sat "for a heated game of gin rummy"—the U.S. was already a year into the deepest recession since the Great Depression. The revamped resort, with 1,504 rooms, 11 restaurants and nightclubs, and a 40,000-square-foot spa—had 2009 revenue of about $170 million through November, nearly 25% less than was budgeted, according to a person familiar with the operation.

"Fontainebleau Miami is a victim of the collapse in room rates, not of flawed renovation," says Bill Lerner, a Las Vegas-based analyst at Union Gaming Group. "It's a great hotel reopened at the wrong time."

Debt ultimately tripped up both ventures. In Las Vegas, BofA, Deutsche Bank, and other lenders refused to fund an $800 million construction loan, saying the project was "$130 million over budget" and in default. Fontainebleau Las Vegas then sued the banks and filed for bankruptcy, blaming the lenders for "brazen breach of contract." In bankruptcy court in February, Icahn paid $156 million for Fontainebleau Las Vegas, on which Fontainebleau Resorts had spent $2 billion.

Sources involved in the Miami Beach negotiations suggest that lenders may accept Soffer and Dubai World's offer, allowing the owners to keep control of the hotel for now. The challenge would then be for the partners to hang on until the economy turns. "The Fontainebleau brand has a lot of value," says Real Capital Analytics' Fasulo. "It's a matter of for whom." |BW|

The Last Picture Show At Blockbuster?

With time running out for the video-rental empire, CEO Jim Keyes desperately needs Hollywood to help him remake the company so it can avoid Chapter 11



A bricks-and-mortar operation in a digital world

TIMOTHY FADEK/POLARIS

By Ronald Grover

For years, the collapse of Blockbuster has been playing out like a slasher film in slow motion. Now the daunting task of writing a happy ending is falling to James Keyes.

On a sunny day in March, Keyes, 55, chief executive of Dallas-based Blockbuster, is in Hollywood for the second time in a week. After visiting Warner Bros. that morning, he will soon head to lunch at Sony and try to pry better terms from the studios on the estimated $1 billion he paid them for DVDs last year. Keyes is trying to buy time to turn Blockbuster into a nimble competitor that can move more of its movies digitally or through the mail. That might fend off Web and mail-order dynamo Netflix—whose market capitalization has rocketed 52% over the past year, to $3.9 billion, vs. a 47% drop, to $62 million, for Blockbuster—and the Redbox vending machines that have become the last-minute movie renter's best friend. "We are a transformation work-in-progress," Keyes, his voice hoarse from bargaining, says as he leans across a table at Starbucks. "But I need a little help."

Blockbuster has been trying for years to shed its skin and instead has racked up debt. In 2009 its share of the $6.5 billion rental business fell to 27% from 36% in 2008, says Bernstein Research analyst Michael Nathanson. It lost $932 million in the last two years as revenues tumbled 23%, to $4.1 billion. Debt was $856 million at yearend.

HOLLYWOOD ALLIES

Keyes came to the company in 2007 after 20 years at 7-Eleven. His biggest asset at Blockbuster is that Hollywood wants to see the company survive. Blockbuster is a place where consumers still congregate to buy DVDs; and while rentals remain 75% of its business, sales of DVDs are far more profitable for studios. They get up to $18 on each one sold, vs. around $4 for a rental, according to Sony Pictures Home Entertainment Chairman Michael Lynton. "We want Jim to succeed," says David Bishop, president of Sony Pictures Home Entertainment. That's why some studios seem to favor Blockbuster over its rivals: On Mar. 23, Warner Bros. signed a deal to let Blockbuster rent DVDs online and through mail order the same day they are released for sale. Earlier, Warner insisted that Netflix and Redbox wait 28 days before offering new flicks.

But Keyes needs to get Hollywood thinking of him as a partner, not a vendor. Keyes says he could conserve cash if the studios would cut his up-front price. Blockbuster asked studios to drop their $18 price tag to as little as $2 in return for stocking more DVDs and giving them a larger share of DVD revenues.

Much of Blockbuster's shelf space is disappearing anyway. The company says in a filing that it closed 374 U.S. stores in 2009 and plans to close up to 545 this year, reducing its total to about 3,500. It has signed deals to provide video-on-demand services to midsize cable operators and hopes to expand to 10,000 the video vending machines it is rolling out with NCR. The chain provides Blockbuster On Demand movies to TiVo subscribers and owners of Web-connected Samsung TVs.

Can Blockbuster avoid Chapter 11? It says it faces a $390 million debt payment in 2012 and raised the possibility of a restructuring in its filing. "This is a company that has two years to turn itself around," says Wedbush Securities analyst Michael Pachter, who gives Blockbuster a neutral rating. Keyes is "making all the right moves. But he has the lousiest job in the world." |BW|

$3.9 billion

Netflix stock market value

$62.3 million

Blockbuster stock market value

Data: Bloomberg News

ADVERTISEMENT



Red, Green, Blue... and Beyond

by Bill Machrone

The annual Consumer Electronics Show is a gotta-be-there event for guys like me. The big news this year was 3D TV, but frankly, I was far more impressed with another technology, one that doesn't require new content or special glasses, but enhances the quality of everything you're watching right now. The fanfare was coming from the Sharp booth.

The new Aquos HDTVs were sleek and stunning and the onscreen images were arresting. These sets had the usual red, green and blue pixels... plus *yellow* pixels. Or, more accurately, sub-pixels, four per pixel. I examined last year's Aquos and the new 4-Color Technology set side by side, under a microscope. Sure enough, there were yellow sub-pixels alongside the others, creating vivid, even dazzling images.

Curious, I asked for a second, closer look. I was struck all over again by the vibrant colors. Not just the yellows, but the reds, greens, and blues. The 2009 Aquos looked great, but the 4-Color Technology Aquos just smokes it.

Then came my moment of cognitive dissonance—I've been around color TVs since the beginning, and no one had ever questioned why you need more than red, green and blue. After all, you can express all colors by blending them properly, right?

Not exactly. You can express all of the colors within a range, but that range, which the engineers call gamut, is limited by the purity and depth of the primary colors. Adding another color expands the gamut and displays colors that weren't there at all or that were merely suggested rather than expressed. Or look at it this way: Sure, red plus green make yellow. But they can't make the deeply saturated yellow that you get from a dedicated pixel. The gorgeous image you see on the display is proof that there's more in the signal than your conventional HDTV could show.

The brilliant picture, I discovered, is due to a complete reengineering of the LCD panel. Sharp's UV^{2}A technology uses a new LCD material that is sensitive to ultraviolet light. The UV precisely aligns the crystals, so they turn completely and in unison, like a precision drill team. They pass as much as 20 percent more light when they're on and are more completely black when they're off, and they switch faster from clear to dark and back again.

UV^{2}A lays the groundwork for 4-Color Technology's 33 percent more sub-pixels and transparent transistors. A new color processor analyzes the incoming signal, adds yellow into the mix in just the right amount and creates hues that you didn't know were missing from your old HDTV. Once you see the brilliant colors and the rich blacks, you appreciate Sharp's level of commitment to video quality, including a new, purpose-built plant.

Never before have movies on TV looked more like film, with deep, lit-from-within colors, rich blacks, brilliant whites, near-infinite color gradation. With the 60- or 68-inch screens and a Blu-ray source, you'll have a truly cinematic experience. The UV^{2}A panel gives the deepest blacks of any LCD and available AquoMotion 240 refresh syncs perfectly with film. Live HDTV? Unparalleled performance.

Once again, quality trumps gimmickry. I'm satisfied that 4-Color Technology redefines HDTV performance. And dissatisfied... it makes my old HDTV look rather sad.

sharpusa.com/AQUOS

SHARP

A Presidency Restored to Health

Obama's improbable win on health-care reform is one for the history books and will boost his credibility

COMMENTARY

By Albert R. Hunt

The success or failure of President Barack Obama's sweeping overhaul of the American health-care system will be clear soon enough. The measure will be revised and amended in successive Congresses. If, over the next decade, it curbs costs and improves outcomes, health care will supersede any other possible legislative accomplishment as Obama's great legacy.

Not that you'll hear Obama insiders talking much about that. They've been careful to keep the historical dimensions of this victory quiet, fearing any recognition would make the President look pretentious. "To the extent he considers history, it's only as a reaffirmation of our capacity to govern ourselves in a real way," says top Obama adviser David Axelrod.

Still, the victory is historic, one that eluded Presidents from Harry Truman through Richard Nixon and Bill Clinton. At several critical junctures it appeared likely to elude Obama, too. Yet even when close associates wavered, his resolve did not. "A lot of Presidents would have concluded it's too risky; maybe get safely reelected and take up health care in year five," says historian Michael Beschloss. "Obama said the rewards were so high, it was worth gambling his Presidency."

Republicans, from House leaders through Senator John McCain, insist the way Democrats pushed the legislation through without a single GOP vote will poison the environment and doom anything else this year, except Republicans' own electoral chances. "Every Democrat who sided with party leaders and liberal special interest groups at the expense of their constituents is going to wear their vote like a scarlet letter," said House Minority Leader John Boehner.

Democrats, who control the House 253-178 and the Senate 59-41, will lose seats this autumn, and possibly even control of one chamber; that's the rhythm of American midterm elections, especially with majorities of this size. It's unlikely health care will be the primary factor in this outcome. Republicans are overplaying their hand by painting reform as a socialistic grab that turns 17% of the economy over to big government. In reality, a government-run scheme—the now infamous public option—like those that exist in many other Western countries was rejected. The closest precedents for Obamacare are the 1974 Richard Nixon health-care initiative, the proposal that Republican Senate Majority Leader Bob Dole floated in 1994, and the Mitt Romney-enacted Massachusetts health-care plan of 2006.



Biden and Obama celebrate legislative victory on Mar. 23

CHIP SOMODEVILLA/GETTY IMAGES

To date, public support for the President's plan has been thin. You can blame the weakness of the Obama message machine or the shrewd actors in the Tea Party for that. Now that the bill is law, that support may grow. There are numerous provisions likely to be popular that take effect this year: a prohibition on insurance companies dropping people from coverage when they get sick or refusing coverage to children with preexisting conditions; a tax credit of up to 35% of premiums for small businesses to make employee coverage more affordable; and more generous prescription drug benefits for Medicare recipients.

Although most Republicans, including the major Presidential hopefuls, are signing pledges to repeal Obamacare, it will be revealing whether this issue is emphasized by Republicans in a few months. Already privately some are saying they should get off it. Republican strategist Ken Khachigian, a former Ronald Reagan aide and now adviser to Carly Fiorina's California Senate quest, suspects that the health-care issue "will fade" as the November election becomes dominated by the economy.

Democratic strategist Paul Begala agrees with Khachigian and has little doubt his party will suffer November losses. Nevertheless, he's convinced the health-care bill will "mitigate" the numbers, because, he argues, the benefits of the measure will become more apparent and misinformation—the creation of "death panels"—will be rectified. The real disaster would have been if Obama hadn't passed health care: "Failure ... would have depressed the Democratic vote and disgusted Independents, who would have concluded Democrats can't run the government."

George Mason University historian Richard Norton Smith adds that if the measure had been defeated, history would have seen Obama as enormously gifted and well-intentioned but ultimately labeled his a "failed Presidency." Instead, he says: "It's a rejuvenated, energized, and in many ways vindicated Presidency." BW


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CLOSING FOR BUSINESS?

Western companies are finding themselves shut out as Beijing promotes homegrown rivals



By Dexter Roberts
Illustration by Tavis Coburn

Not so long ago in China, Western business executives traveling to the provinces could expect a hearty welcome and a banquet with endless toasts of *maotai* liquor. In February, however, representatives of General Electric and a dozen other U.S. companies got a taste of the way commercial relations have been changing. They were in Wuhan, a city of 9 million on the Yangtze River, for a seminar on water-treatment technology organized by the U.S. embassy. At a dinner after the meeting they were supposed to have a chance to mingle with top local officials. But at the last minute, Wuhan's mayor canceled his keynote speech and backed out of the gathering. That same day the provincial party secretary and governor begged





STR/AFP/GETTY IMAGES

off a separate event for American Ambassador Jon M. Huntsman Jr. One attendee, who won't be quoted by name, speculates that the Wuhan officials were responding to direct orders from the central government in Beijing not to meet the Americans. The provincial government acknowledges that the original lineup was changed but notes other officials attended the events.

Nearly a decade after China's entry into the World Trade Organization, many foreign companies say the warm reception they once received has turned frosty. While China can still be highly profitable, some question how long that will last as Beijing changes the rules to give a lift to its domestic companies, especially state-owned enterprises. A new government procurement program known as "indigenous innovation" features rules favoring local firms: It could block sales worth billions of dollars a year, says Joerg Wuttke, director of the European Union Chamber of Commerce in China. Beijing has written strict standards for everything from cell phones to cars, often couching them in a way that gives an advantage to domestic producers. A recently revised patent law could force foreign companies to hand over key technologies to Chinese bureaucrats. And anti-monopoly regulations have been used to limit foreign access to sectors such as construction machinery and energy. "They have moved away from a level playing field to benefit their own companies," says Wuttke. Multinationals "are seeing the golden China opportunity become a mirage," says the China government relations chief of a major tech supplier, who would not be named for fear of reprisals.

Trade associations can speak more openly. A Jan. 26 letter to the White House from the U.S. Chamber of Commerce, the Business Software Alliance, and more than a dozen other groups representing hundreds of multinationals such as Microsoft, Boeing, Motorola, Caterpillar, and United Technologies, warned of "systematic efforts by China to develop policies that build their domestic enterprises at the expense of U.S. firms." The signatories asked the Administration for its "urgent attention to policy developments in China that pose an immediate danger to U.S. companies."

Why a chill now? Chinese look across the landscape of their economy today and see much that could be improved. After 30 years serving as the workshop of the world, mainly producing low-value goods for foreign brands and distant markets, they want to move up the value chain. To date they have only been able to capture a fraction of the value of a Nike shoe or Apple iPhone. And they know they have a poor record in creating global brands. Apart from telecom equipment maker Huawei, notebook giant Lenovo, appliance marketer Haier, and perhaps consumer electronics maker TCL and car companies Geely and Chery, they have few champions. Even at home, General Motors and Volkswagen vie for the top spot, while Nokia sells the most handsets of any company in China, with a 32.9% share. "People feel that foreign brands have taken too much market share," says Wang Yong, director of the Center for International Political Economy at Peking University.

Although China has been able to build a $227 billion trade surplus with the U.S., its manufacturing might has brought it huge problems with pollution and energy waste. The Chinese understandably want something better. "They want sophisticated international companies and they want to give them a leg up," says Brookings Institution senior fellow Kenneth Lieberthal. The Chinese drive resembles Japan's efforts in the 1960s to become a global player, though China has opened up much more. Foreign companies have invested some $600 billion into China since 2001. Even as friction began to rise, U.S. companies increased their investment from $2.9 billion in 2008 to $3.6 billion last year.

On top of all this, China has emerged from the global financial crisis largely unscathed. As a result, political analysts say, Chinese look at the rest of the world and feel a lot less awe and admiration than they once did. There is also a sense that the previous leadership of President Jiang Zemin and Premier Zhu Rongji gave away too much—such as slashing tariffs on agricultural products and ending local-content requirements for foreign automakers—in their desire to enter the WTO. Now, China feels it should assert its own economic interests. If that involves throwing its weight around, so be it.

PUSHBACK

How China keeps foreign business in check

Finally, China sees how other countries—notably the U.S.—have used standards, regulations, and buy-local policies to



BATTLING BEIJING

After Chinese hackers broke into its data, Google on Mar. 22 said it would stop censoring its search results in China, as required by law. Instead, mainland searches will be routed through Google's unfiltered site in Hong Kong. The official Xinhua news agency said the company is "totally wrong" to take the step.

Students hold a candlelight vigil outside Google headquarters in Beijing

build their own industries. Beijing feels more than entitled to do the same. The U.S. Trade Representative's Office started 28 cases against Chinese companies last year. And "states like California have wide latitude in their procurement policies, so they can give American companies an advantage," explains Nicholas Lardy, senior fellow at the Peterson Institute for International Economics. If foreign companies complain publicly—which they often don't, since Beijing has shown itself capable of using inspections, delayed approvals, and courts to make life miserable for those who speak out—China now usually says, show us where we are violating WTO rules.

China's leadership does not want the situation to spin out of control. The Commerce Ministry has assured foreign investors they are still welcome, and on Mar. 2 officials met with executives from over two dozen companies and associations to hear their concerns. At the close of the National People's Congress on Mar. 15, Premier Wen Jiabao told reporters the government would try "to level the playing field for foreign companies." Wen also met with foreign delegates at the China Development Forum on Mar. 22, saying trade and currency wars "won't help us cope with difficulties but just curb cooperation." Ambassador Huntsman declared himself "convinced that blue skies are already on the horizon" in a speech at Tsinghua University in Beijing a few days earlier. Investment keeps rolling in. Ford Motor, for example, has recently been ramping up in China. And with President Hu Jintao expected to visit the U.S. this year, both sides will no doubt extend olive branches before he arrives.

Some cool-headed analysts call the current complaints overblown. Charles Freeman, a China expert at the Center for Strategic & International Studies in Washington, argues that Beijing can't shut out foreigners because it needs their intellectual property: China's technology lags Western, Japanese, and Korean efforts in many key sectors. Chinese wind turbines, for instance, are inferior to products made abroad, he says, but wind is key to Beijing's goal of weaning itself from coal power. "They won't wait for Chinese innovation," says Freeman, who served as chief China trade negotiator for the U.S. Trade Representative in the George W. Bush Administration. "They will choose American, European, or Japanese products that are cheaper."

GOOGLE GLARE

Those are sensible comments. Yet the frictions are mounting. The largest potential troublemaker is the fight over China's currency, the yuan (page 38). On Mar. 16, a group of U.S. senators unveiled a bill to levy tough sanctions against China for manipulating its currency to promote exports. Brooking's Lieberthal says the economics of that argument are weak: A 20% appreciation of the yuan would just cheapen China's cost of imports, like oil and iron ore, that it uses to make exports, so the final costs of U.S.-bound products would rise only slightly.

The yuan is a political issue, though, and things could get ugly whatever the economic arguments. The flap over Google's exit from China over censorship rules adds heat to the U.S.-China debate, even though it has nothing to do with currency or trade protections. China, meanwhile, sees a weak U.S. economy as a threat to the value of its vast holdings of Treasury bills. And Beijing is livid over the arms sales to Taiwan, President Barack Obama's February meeting with the Dalai Lama, and a Mar. 11 State Dept. report criticizing China's human rights record.

The efforts to develop homegrown technology are what's really worrying U.S. business. Beijing has crafted "very direct policies of favoritism for Chinese state industry that are hitting foreign companies," says James McGregor, author of a book on investing in the mainland and former chairman of the American Chamber of Commerce in China. "We are seeing a sea change."

"INDIGENOUS INNOVATION"

This policy favors local technology in computers, software, and new energy equipment for government purchases worth billions of dollars. GE's wind division, software companies SAP and Microsoft, and computer makers such as Dell and HP could lose contracts under these guidelines.

PATENT LAW

A new measure could force foreign companies to hand over patents if they are seen as using them to compete "unfairly." The law may also require foreign drugmakers and software writers to first register in China any innovations developed in their mainland labs, spurring fears of a loss over control of their technology.

STANDARDS

China issues more than 10,000 product standards each year, some written to keep foreigners out of the market. Several Italian appliance manufacturers were shut out by rules requiring hotter-burning gas stoves. And tiremakers say the rules make it less profitable to sell in China.

APPROVALS

Bureaucratic foot-dragging on licensing for foreign banks and insurers restricts access and boosts Chinese rivals. One insurer says he can apply to open only one branch at a time and that it takes more than 18 months to get the green light. So some foreign companies have no more than a handful of branches.

New rules giving preference to Chinese suppliers for government projects make it difficult for General Electric, Denmark's Vestas, and other foreign wind turbine manufacturers to win contracts in China, a market worth some $14 billion annually. Hewlett-Packard says China's consumer protection agency has criticized its handling of warranties and repairs for certain notebook computers, the first time in memory HP has had such troubles. On Mar. 16 officials in Zhejiang province impounded clothing made in Europe by Versace, Hugo Boss, and other luxury brands. A government agency said many garments failed quality or safety tests, a claim vigorously rejected by the companies. And last year international express mail carriers were barred from domestic deliveries of letters and documents. The rule "is unfair and ... it's bad for China to keep the international companies out," UPS Chairman D. Scott Davis told analysts in a conference call last fall. "It seems kicking the foreigners in the teeth is in these days," says American consultant Duncan Clark, a 15-year resident of Beijing.

"TONGUE LASHING"

China's membership in the WTO was supposed to make things easier on foreign investors, who used to be treated like honored guests and wooed with tax breaks and free land. After President Hu Jintao and Premier Wen Jiabao took over in 2002, things started to cool. That has left multinationals far less bullish on China. While foreigners have made substantial profits on the mainland, last year confidence about future earnings took a tumble, according to separate surveys from the U.S. and European chambers of commerce. Both groups report a majority of members make money in China, but the ranks of the profitable are shrinking. Just a third of European companies now say they're optimistic about future profits, down from half the previous year. In a separate survey by the American Chamber in Shanghai, 39% of companies say revenues fell in 2009, the largest number since 1999.

Tit-for-tat actions against Chinese tires and steel pipes and American chicken could flare into a full-blown trade war. Washington is mulling whether to respond to Chinese favoritism by seeking punitive measures against Beijing at the WTO and the U.S. International Trade Commission, says a senior Commerce Dept. official. "What worries me is that the Chinese-American relationship is becoming more antagonistic," says Kai-Fu Lee, a former senior executive for Microsoft and Google in China. "That is not healthy."

"THE CHINESE ARE VERY GOOD AT SMASHING THE NAIL THAT STICKS UP," SAYS AN EXECUTIVE WHO FEARS RETALIATION

Much of the angst stems from the indigenous innovation policy. First introduced as an ill-defined national goal several years ago, the initiative gathered speed last fall when Beijing began offering tax breaks and subsidies to Chinese companies and gave them preference in state contracts. Provincial and municipal governments across China have issued lists of everything from mobile phones to traditional herbal remedies that can be purchased by their agencies. Hardly any include goods made by foreign companies, even if they're produced in China. Shanghai, for example, released a list of over 500 approved products—Lenovo PCs, solar panels from Chaori Solar, and more. Only two items come from enterprises with foreign ties. Such policies aren't technically in violation of WTO rules, since China hasn't yet signed an agreement that covers government procurement. Although Beijing says it aims to sign this year, that may not have much meaning, since it has asked for a phase-in period of 15 years.

A key issue will be whether China defines government procurement to include schools, hospitals, and state-owned enterprises. A broad definition could put billions of dollars of sales of tech goods off-limits for non-Chinese companies. "These rules in essence will keep out not just American companies over here but also [block sales by] American companies operating in China," says John Frisbie, president of the U.S.-China Business Council, a Washington lobbying group representing more than 200 multinationals such as Citigroup, IBM, and Microsoft. Beijing, he says, has "crossed a line."

A patent law that took effect in October includes a rule that would force companies to file patents or trademarks in China before doing so overseas if they want to qualify for government procurement. Companies say that makes it impossible to sell any product developed overseas and would give Chinese bureaucrats access to trade secrets. The law could compel companies that use patents to "compete unfairly"—as defined by a vague 2008 measure—to release them for use by rivals. Foreigners rarely push back publicly for fear of angering the Chinese. An executive from an international express carrier says global delivery companies might win a WTO case over Beijing's rules barring them from carrying domestic letters, but he says he would never pursue a case alone; his company would almost certainly face harassment. "The Chinese are very good at smashing the nail that sticks up," he says. Many foreigners refrain from taking legal action because they feel the justice system favors domestic enterprises. "We complain but we don't sue," says Mark Cohen, an attorney at Jones Day in Beijing.

LOCAL HEROES

Domestic companies such as Lenovo have benefited from the "indigenous innovation" policy that gives them preference in government procurement. Cities across China have issued lists of computers, phones, medications, and myriad other Chinese-made products that are approved for purchase by local agencies.

A Beijing billboard trumpeting one of the mainland's rare brand champions



DOUG KANTER/BLOOMBERG

That attitude was reinforced when French electronics maker Schneider Electric last April settled a three-year-old patent dispute with Chint Group, a maker of products such as transformers and circuit breakers, for $23 million. Western attorneys familiar with the case say Chint had actually lifted Schneider's technology, not the other way around. Thomas Pattloch, IP officer for the European Delegation in Beijing, says the case illustrates so-called junk patents used by the Chinese against companies whose patents they have infringed upon. "The court did everything they could to ignore the evidence Schneider presented," says Pattloch. A Schneider spokeswoman says the company disagreed with the court's initial decision and declined comment on the settlement. Chint disputed the account but declined to provide details, citing a privacy agreement. The court did not respond to requests for comment

BURIED IN REGULATION

Beijing's penchant for rule-making has created another big barrier. Every year, China issues more than 10,000 new standards governing industries from mobile phones to autos. That's more than the rest of the world combined, says Klaus Ziegler, the standards officer at the delegation of the European Commission to China. The rules, ostensibly to protect the health and safety of consumers and to ensure that products will work in China, are often crafted in a way that boosts Chinese companies, foreign investors say.

Germany's Continental must grapple with rules mandating that all tires sold in the country be imprinted with Chinese characters and other mainland-specific information. Although there's a global standard for such specifications the Chinese insist on their own rules—so Continental and other tire makers must make scores of special molds that cost nearly $70,000 apiece. That's not a huge problem for mass-market tires, but it can devastate profits on specialty products such as tires for industrial vehicles.

Gas cooking stove makers faced similar problems. Buried in the 50 pages of regulations about gas-fired appliances is a clause that says burners must withstand temperatures above 700C. That's higher than standards elsewhere, and it means burners can't be made of aluminum—the material most commonly used by European manufacturers. The result: Several Italian manufacturers were shut out, says EC standards officer Ziegler. "China eliminated those Italian producers," he says.

Chinese software piracy is "intractable" and "deprives U.S. software companies of literally billions of dollars each year," Robert Holleyman, president of the Business Software Alliance told the House Foreign Affairs Committee on Mar. 10. In another side of the software issue, an executive familiar with German software maker SAP says Beijing offers tax breaks and other incentives to companies that buy products from local rival Kingdee International. Kingdee didn't respond to requests for comment, and SAP declined to address the issue.

In services, China remains tough to crack. Insurance, for instance, was supposed to open up after Beijing joined the WTO. Yet Chubb, Liberty Mutual, and Zurich can apply to open only one new branch at a time, and it typically takes more than 18 months to win approval. "There is this mentality that they want to help the local companies," says an executive with a foreign insurer. "And the easiest way to do that is to protect them from foreign competition."

Some Westerners believe all these troubles can be traced to China's negotiations to join the WTO. In the rush to gain access to the huge market, many corners were cut, and trade officials simply hoped Beijing would interpret the deal in a way outsiders would consider fair. "People were focused on the enormity of what was being accomplished just by bringing China into the WTO," says an executive with a Western bank in Shanghai, who says capital requirements and recalcitrant bureaucrats have restricted his company's expansion. "They thought they could take care of [the details] later." |BW|

–With Cornelius Rahn, Steve LeVine, Aaron Ricadela, Connie Guglielmo, Susanna Ray, Brian Womack, and Helen Yuan

BREAKING UP A BIPOLAR ARGUMENT

Chinese executives who favor a stronger yuan—the U.S. position—may help settle the tiff between Washington and Beijing

By Belinda Cao and Judy Chen



China has kept the yuan at 6.8 per dollar since July 2008

Is China's currency too cheap? That's a familiar debate between American leaders, who favor a stronger yuan, and Chinese officials, who say it is valued properly. Now a number of Chinese business executives are coming forward—and speaking in favor of the U.S. position.

Lenovo CEO Yang Yuanqing says currency appreciation would boost Chinese consumers' purchasing power. "We may not worry too much about exporters if we can conduct more yuan-denominated trade," he told reporters in March. Qin Xiao, chairman of China Merchants Bank, says an end to the yuan's peg to the dollar would let lenders set market-based interest rates. And Chen Daifu, chairman of Hunan Lengshuijiang Iron & Steel Group, says a stronger currency would cut import costs. "Yuan appreciation will bring us benefits because we import several billion yuan worth of ore every year from abroad," he told Bloomberg News.

While these comments conflict with those of Premier Wen Jiabao, who said on Mar. 14 that criticizing the exchange-rate policy amounted to "protectionism," they are in line with traders who expect the government to let the yuan appreciate later this year. Wen has kept the yuan at about 6.8 per dollar since July 2008 to protect China's exporters during the global recession, after a 21% advance in the previous three years. Contracts linked to its future value predict the currency will break its dollar link by July.

U.S. lawmakers have called on President Obama to use the threat of trade sanctions to force an end to a currency regime they blame for hurting U.S. manufacturers' competitiveness. As Chinese business leaders speak out, it becomes possible for Beijing to act without being seen as bending to U.S. pressure. "A coordinated message with these leaders changes the narrative," says Daniel Michaeli, a Sino-American relations expert who runs the Asia Ruminations blog.

"We need to emphasize the benefits of yuan gains," Zhang Yanling, vice-chairman of Beijing-based Bank of China, the nation's biggest foreign-currency lender, told Bloomberg News. "The U.S. should also be talking about both aspects of the issue. We shouldn't politicize it or become emotional."

Companies in low-margin Chinese industries, such as textiles and furniture, stand to lose the most from appreciation, said Zhang Wei, vice-chairman of the China Council for the Promotion of International Trade; some may even face bankruptcy, he said. Companies with dollar exposure will fare better. China Eastern Airlines, the nation's No. 2 carrier, would increase profits by 280 million yuan ($41 million) for every 1% annual yuan gain because of its dollar debt, President Ma Xulun said at a shareholders' meeting in March. The airline's shares climbed 17% in the past month in Hong Kong, compared with 4% for the MSCI China Index. Morgan Stanley has estimated that a 5% appreciation in the yuan this year would have an average 2% positive impact on Chinese companies' earnings.

Chinese bankers blame the yuan peg for disrupting money markets. China's dollar purchases to maintain the link have driven currency reserves to $2.4 trillion and have flooded the financial system with yuan. Chinese investors held $889 billion of Treasuries on Jan. 31, the biggest overseas holders of such debt.

MARKET-DRIVEN RATES

With China's benchmark deposit rate now 2.25%—less than the country's rate of inflation but far above near-zero U.S. rates—the central bank can't raise rates without attracting speculative capital. "If we don't reform the exchange-rate regime, how can we price interest rates based on the market?" asks Qin of China Merchants, the nation's No. 5 lender.

Other Chinese business leaders caution the Americans to be careful what they wish for. Says Bank of China's Zhang: "If the yuan is expected to be a strong currency, neighboring countries will prefer to hold the yuan instead of the dollar. Will this be good for the U.S.?" | BW |

—With Frederik Balfour, Irene Shen, Luo Jun, Michael Forsythe, Garfield Reynolds, and Shiyin Chen

SHENG LI/REUTERS



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Eddie

Five years ago, when Eddie Lampert merged Kmart and Sears into a mega-retail holding company, the hedge fund guru was hailed as the Next Buffett. Sears Holdings was going to be a retail empire, a real estate play, and a new Berkshire Hathaway—a vessel for all the acquisitions Lampert would make. Then came the crash, putting those dreams on hold and leaving Lampert...

STUCK WITH SEARS

By Roben Farzad and Michael Arndt
Illustration by Daniel Adel

Our story begins with a tale of two Buffetts: the real one, of course, and the financier who five years ago was being hailed (by this magazine, among others) as the Next Buffett. ¶ For the real Buffett, business is good these days. Warren Buffett's annual letter to Berkshire Hathaway shareholders, released in late February, celebrated a triumphant return to form. By seizing opportunities, he wrote, Berkshire had emerged from the Panic of '08 stronger and more profitable. "When it's raining gold," he crowed, "reach for a bucket, not a thimble." ¶ For the Next Buffett—hedge fund guru Edward S. Lampert, 47, who had posted 29% average annual returns since founding his fund in 1988, then created Sears Holdings in 2005 by stitching a deeply wounded Kmart to Sears' once-venerated brand—business is not so good. Lampert's shareholder letter, released around the same time as Buffett's, came out swinging at the critics

who now outnumber his fans. Lampert blamed journalists, analysts, and rating agencies for much of the trouble plaguing his retailing empire, arguing that they apply a double standard to Sears Holdings when they blame "our investment choices for our declining sales" while citing the economy for sales declines by rivals like Wal-Mart Stores and J. C. Penney.

Still, Sears Holdings has performed 19 percentage points under the Standard & Poor's 500-stock index since its creation in 2005, and 29 percentage points under Wal-Mart during the same period. Contrast that with Buffett's Berkshire Hathaway. It has posted results that outperformed the S&P 500 in four of the past five years—27 percentage points better than the market in calamitous 2008.



Lampert, Kmart's Aylwin Lewis, and Sears Roebuck's Alan Lacy in 2004

Lampert can point to improvements recently at Kmart. Throughout 2009, Kmart had smaller declines in same-store sales than Target, and it beat Wal-Mart by this metric in the last two quarters, too. He has closed 66 moribund Sears stores, which he says raises cash in most cases, and he has a new effort afoot, applauded by some analysts, to make Sears' signature brands, Craftsman and DieHard, available through other retailers for the first time.

This will create a new revenue stream, but other analysts worry it will also mean there's less reason for customers to walk into a Sears, especially if Lampert begins selling Kenmore appliances outside. "Kenmore *is* Sears," says Credit Suisse analyst Gary Balter. "The moment they take that outside the store, they could lose a big, big part of their traffic."

As risky as they may seem, such moves are not likely to turn the tide Lampert's way, according to company watchers. "If he has a strategy other than cutting costs, I haven't seen it," says James E. Schrager, professor of entrepreneurship and strategy at the University of Chicago's Booth School of Business. "What is their concept?"

Tactical retailing decisions of this kind are no doubt necessary, but they're a long way from the bold financial stratagems analysts expected from Lampert when he burst onto the scene five years ago with the creation of Sears Holdings. The Buffett comparisons were based on his approach as much as on his gaudy results. Just as Buffett had turned a listless New England textile maker into one of the most successful investment vehicles in history, Lampert would use a rejuvenated Sears as a Buffett-like holding company with which to mount acquisitions, some to keep and grow, some to be flipped for cash. Sears Holdings would be both a dynamic investment vehicle and a brilliant retailer.

At the moment, Schrager and others say, it is neither. Although downmarket retailers tend to do relatively well in recession, neither Sears nor Kmart has snapped out of its senescence. Sales are down and keep falling. Per-store sales have declined for the past five years, and total revenue has slumped to $44 billion, its lowest level since the 2005 merger. Net income is slipping and, according to its filings, the company has spent more on stock buybacks than it has invested in stores or acquisitions. No one, other than Lampert, who controls 53.1% of the company (despite having sold 4.6 million shares in March), seems to have staying power in the C suite. Sears remains without a permanent CEO, having gone through three with Lampert as chairman. An interim CEO, W. Bruce Johnson, has been in place for two years as a protracted head hunt goes on.

Along the way, Lampert has starved the stores of capital spending, according to Balter, while doling out $5.43 billion on those share buybacks to help lift per-share results. This lack of spending, Balter says, has a direct impact on the quality of the shopping experience. And soon the customers won't have to visit Lampert's stores to buy his best products.

Johnson acknowledges the risk that moving Craftsman and DieHard into new retail channels could cannibalize sales at Sears and Kmart. Still, he argues, the gamble is worth it. "We have great potential, unrealized potential to this point, with our major brands," Johnson says. "But we're not going to do that recklessly and without thought."

By the company's own reckoning, however, previous retail restructuring efforts have fizzled. At first, Lampert proposed turning Kmart stores into Sears locations, which would move Sears beyond conventional malls. Before the deal was completed in March 2005, Sears bought 50 sites from Kmart. The post-merger plan was to convert them and hundreds more into freestanding Sears stores.

These new off-the-mall stores were called Sears Essentials and carried goods from both retailers, mixing Kenmore appliances with Martha Stewart housewares. After several stabs at finding the right chemistry, the company pulled back. "We found we just couldn't get the kind of sales and profit lifts to justify the investment in these stores," Johnson says.

Kmart and Martha Stewart parted company in January.

CALE MEREGE/BLOOMBERG


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Stewart had few kind words for Kmart or Sears as they were breaking up last fall, claiming in a CNBC interview that the retailer had sullied her brand. "The quality is not what I am proud of," Stewart said. "Have you been in a Kmart lately? It is not the nicest place to shop." She now sells her line through Macy's.

Sears points to a conciliatory press release that Stewart issued after that interview. "We wish our friends at Kmart and Sears Holdings all the best," it said. Besmirching Kmart "was not my intent."

Sears execs also say that in the years after Lampert acquired the companies, they were bogged down in integrating the two chains, then got walloped by the recession. As for why Lampert never followed the path of his idol into a Berkshire-like acquisition mode, the credit crisis of 2008-09 explains much of it. Some analysts also think Lampert overlooked a major component of the Buffett model. "When Buffett buys a company, he bets on management; that's his No. 1 principle," says Howard Davidowitz, chairman of Davidowitz & Associates, a retail consulting and investment banking firm in New York. "Buffett learned long ago how insane it was to run a fabric mill on his own. So how is Lampert, a guy with a hedge fund in Connecticut, running Sears and Kmart?"

Lampert, who declined to comment for this story, still has his fans. "Profitability, even if done by managing inventory and cutting costs, is good," says Ivan Feinseth, chief investment officer of Alpha-Works, a New York hedge fund bullish on the shares though it has no stake in the company. "Look, are there better places to shop? Absolutely. But Sears is an option on Lampert, not as a retailer, but as a financial engineer."

Lampert's own view, as expressed in his latest chairman's letter, is that Sears Holdings is doing pretty well given the crummy economic environment of the past two years. The real problem, he insisted, is that too many people who follow the company misunderstand how it works. "We hope that those who may have doubted us in the past are willing to keep an open mind," his letter stated. "In our case, it turns out that our performance far exceeded many observers' expectations and we hope to receive credit for this performance in the form of higher credit ratings and more balanced analysis. Simplistic analyses, which automatically prefer capital investment to share repurchases as a use of cash that 'benefits' bondholders, ignore the fact that negative or below market returns on invested capital are as harmful to creditors as to shareholders."

Lampert has a point, but he overlooks another one. His preference for buybacks over capital investment necessarily disadvantages his retail operations—yet he has insisted that he took over Kmart and then Sears because he wanted to operate them as retailing companies. Analysts have just as consistently seen a different motive. They looked at the chains and their combined count of nearly 4,000 stores as a real estate play, hard assets that Lampert bought cheaply and could flip for a fortune.

Consider that in 2004 Lampert sold some 65 Kmart stores and acreage to Home Depot and Sears for $946 million. The analysts' conjecture seemed to be seconded in late 2004 when Vornado Realty Trust bought a 4.3% stake in Sears as Lampert was about to merge it with Kmart. (Vornado sold its shares by yearend 2005, for a net gain of $26.5 million.) Since then, though, the Sears chairman has only dabbled in small deals. In 2007 he sold the Sears' Canadian headquarters in Toronto to Ontario for $81 million (Canadian), leasing back the space. That same year he also got a $21 million pretax gain by selling the chain's fashion center in Los Angeles to an undisclosed buyer.

In today's commercial real estate glut, fewer buyers would want Kmart's big boxes or the Sears stores that anchor suburban shopping malls. "The market for this kind of space right now is relatively nonexistent," says Neil Stern, senior partner with McMillan Doolittle, a Chicago retail consulting firm. "There's a flood of vacancies, large-scale bankruptcies, and department-store brand consolidations."

"What Lampert did years back was brilliant," says Stern. "He sold Kmart stores to Sears, got cash, and turned around and bought the whole company. Everyone then extrapolated that he could keep doing that. But times are different." On the other hand, Sears was able to expand deeper into small-city markets with what it calls Hometown stores, which are independently owned and staffed to Sears' specifications. It has more than 1,000 today, after adding 60 last year, and it plans to add 100 more in 2010.

Sears is also testing a new concept at a single location in suburban Chicago. Called Mygofer, it's essentially a huge, well-stocked warehouse where shoppers can pick up goods they've ordered on the Internet at home, on their smart phones, or at kiosks in the store.

Such moves cost Sears little in capital expenditures, which must be attractive to a man who doesn't like to pump money into bricks and mortar. This reticence is why Lampert is often faulted for neglecting the company's stores. Balter, the analyst with Credit Suisse, says too many stores are typically dirty and out of stock. "Customers have a choice every day," he

SEARS: INVESTMENT WELL-SPENT?

When Sears was merged into Lampert's Kmart in March 2005, the hedge fund billionaire said his new holdings had "the potential to be a great company with a truly great retail business." Here's how things have turned out.

	THEN*	NOW*
SHARE PRICE**	132.52	107.47
REVENUE IN BILLIONS	$56	$44
NET INCOME IN MILLIONS	$884	$235
STORE COUNT***	3,846	3,921
CAPITAL INVESTMENT	$1.1 BILLION	$361 MILLION
SAME STORE SALES****	-10.4%	-5.1%
DEBT IN BILIONS	$4.9	$2.5

*Figures are fiscal years ended Jan. 29, 2005, and Jan. 30, 2010; fiscal 2005 figures are pro forma
**Share price as of Mar. 24, 2005, and Mar. 22, 2010
***Includes Canada and specialty stores
****2005 data are for 39 weeks ended Jan. 26, 2005, for Kmart
Data: Sears Holdings



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says. "Why are you going to go there? That's the challenge."

That may help explain why the company's same-store sales have declined every year under Lampert's ownership. Sears has consistently underspent its rivals on capital investments. The company committed $361 million in capital spending in the year that ended Jan. 30, less than the $424 million it spent to buy back shares during that period, according to company documents. Compare that with the capital spending by Target ($1.73 billion) and Wal-Mart ($12.2 billion) over the same period.

Lampert has dismissed these comparisons from the start, as does Johnson. Yes, the CEO says, shoppers might happen upon faded outlets, "but most of the stores look pretty good." And capital investment doesn't automatically produce higher sales.



Non-mall outlets like this one in St. Petersburg, Fla., didn't pay off

At a Kmart in Chicago, customers say they come for the low prices. Laura McBride, a homemaker shopping with her husband, Richard, a pipefitter, prefers it over Wal-Mart and Target. She shops at Kmart twice a week, after scanning ads for what's on sale. "I love the prices," she says. "Kmart fits my budget. I find more sales here. Things are cheaper."

Those low prices hurt Kmart's performance. Balter thinks it would be better off if Lampert sold Kmart and focused on Sears. He notes that on a per-square-foot basis, Kmart is only a quarter as productive as Wal-Mart, but concedes that a sale or spinoff is highly unlikely in the present retail environment.

Although Sears is smaller than it used to be, it still is a retailing behemoth. It is the nation's fourth-biggest general retailer, behind Wal-Mart, Costco, and Target, with fiscal 2010 sales of $44.04 billion and 3,921 stores. Including Canada, it has more than 300,000 employees. Sears, in 2001, was far and away the biggest vendor of big-ticket household appliances and white goods with a market share of 41%. It's still No. 1, though that share is now 31.7%.

Sears' gross margin came to 27.7% in fiscal 2010, which ended Jan. 30. The margin has ranged from 27.1% to 28.7% since Lampert merged Sears with Kmart in early 2005, according to company Securities & Exchange Commission filings. Target regularly posts margins of 30%, thanks in large part to its greater volume of high-priced consumer electronics. Wal-Mart lags both, with gross margins of 23.5% over the past few years. Wal-Mart, however, relies on food for almost half its revenue and the grocery business is notoriously low margin.

Lampert has always contended that his rivals are spending money on store expansions and updates foolishly, writing in one of his annual letters: "We do not subscribe to the view (seemingly widely held) that more is better, or that there is a certain amount that must be spent on cap-ex every year." With 2,235 full-line stores between Sears and Kmart today, the company has more than Target (1,684), J. C. Penney (1,110), or Kohl's (1,060). "The issue for Sears Holdings is therefore not one of building more stores, but rather one of making our existing stores more productive and relevant to our customers," Lampert argued.

Ana Lai, an analyst with Standard & Poor's, says store counts tell only part of the story. "The operating performance has really been below expectations. Its competitive position has really deteriorated against peers such as J. C. Penney, Macy's, and Kohl's. Their execution hasn't been all that good either. They need to invest in their stores to make them more attractive and to provide shoppers with a better experience."

Lai is still looking for the promised sales synergies between Kmart and Sears. "The longer this continues, the more their position will weaken." She sees nothing in Sears' strategy that pulls the company out of its "manage-the-decline" slide.

None of these analysts, in fairness, has had to manage two aging retail chains through an epic recession. So it's worth asking: Where would Sears and Kmart be today if this presumptive New Buffett hadn't swooped in five years ago? Probably in worse shape than they are. Other marginal retailers—Circuit City, Linens 'n Things—have folded. Feinseth of AlphaWorks sees no other hope for once-bankrupt Kmart vs. the duopoly that is Wal Mart-Target.

"THEY NEED TO INVEST IN THEIR STORES TO MAKE THEM MORE ATTRACTIVE AND PROVIDE SHOPPERS WITH A BETTER EXPERIENCE"

Indeed, all the tangible goodwill of Sears' many household brands seems to pale in comparison with the intangible premium of Lampert's name. According to Bloomberg data, Sears shares, at their 107 close on Mar. 22, enjoy a $40 premium over analysts' average 12-month price target—tops in the S&P 500.

Managing a business and managing lofty expectations are two very different things. |BW|

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CEO PAY DROPS, BUT... CASH IS KING

BLOOMBERG BUSINESSWEEK'S EXCLUSIVE FIRST LOOK AT THE 2009 COMPENSATION OF CHIEF EXECUTIVES AT 81 BIG COMPANIES

By Jessica Silver-Greenberg, Tara Kalwarski, and Alexis Leondis
Photo Illustration by Arthur Hochstein

ORIGINAL PHOTOGRAPH BY PHILLIP SIMPSON/PHOTONICA/GETTY IMAGES

Here's a bit of good news for the Washington finger waggers who think executive compensation has gotten out of hand: A survey of 81 big companies shows that CEO pay dropped by 8.6% last year. Now for the worrisome twist: The cash portion of their compensation rose 8.3%. ¶ That's a sign that companies are de-emphasizing long-term incentives for their top guys, a particular bugaboo of



Kenneth Feinberg, President Barack Obama's executive pay cop. Feinberg and many shareholder activists argue that CEOs should have a stake in the success or failure of their companies. The value of stock-option grants, that much loved tool of incentive compensation, dropped 30% last year for the CEOs included in the analysis.

"To the extent there is more emphasis on cash than stock, that's unfortunate," says Feinberg in an interview about the survey. But, he adds, "every company is different. You can't across the board make any general evaluation."

For an early peek at how CEOs prospered—or didn't—*Bloomberg BusinessWeek* examined data from proxies filed by companies in the Standard & Poor's 500-stock index by Mar. 12. To get an accurate comparison to the previous year's numbers, we included only CEOs who sat in the big chair in both 2008 and 2009. The data was compiled by Graef Crystal, a long-time compensation analyst.

Assuming the trend holds for the rest of the S&P companies, it appears CEO compensation may have fallen for the third year in a row. Executive pay peaked in 2000, when average total compensation hit $14.6 million for CEOs of S&P 500 companies, according to research by Carola Frydman of Massachusetts Institute of Technology and Dirk Jenter of Stanford University. Their work shows that pay was roughly 40% off that high in 2008.

Some of last year's biggest losers sit atop the 20 financial firms included in the analysis. Overall, those companies cut CEO compensation by $28 million in 2009, accounting for almost 37% of the total drop among the 81 CEOs. Eleven were banks that received money from the Troubled Asset Relief Program and had to adhere to federal guidelines that restricted cash bonuses for top executives.

Citigroup's Vikram S. Pandit in February 2009 voluntarily slashed his annual pay to $1. The previous year it topped $38 million. Citi's stock price remains down 93% from its high in 2006, and Pandit has vowed not to take a raise or incentive compensa-





David Cote
HONEYWELL INTERNATIONAL
At his own suggestion he took no bonus. His total pay was reduced 57%, to $13.2 million, in 2009.

BIGGEST DECREASES IN 2009 CEO PAY

Among 81 large companies, in millions*

COMPANY	CEO	SALARY AND BONUSES	STOCK AND OPTION AWARDS	ALL OTHER	TOTAL COMPENSATION	CHANGE IN PAY FROM 2008	STOCK TOTAL RETURN IN 2009
Citigroup	Vikram Pandit	$0.1	$0.0	$0.0	$0.1	-100%	-51%
United States Steel	John Surma	1.3	0.0	2.2	3.6	-75	51
Motorola	Gregory Brown**	1.7	6.4	0.4	8.5	-65	75
Life Technologies	Gregory Lucier	4.5	0.0	0.0	4.5	-60	124
PACCAR	Mark Pigott	1.4	1.6	1.2	4.2	-58	29
Bank of America	Kenneth Lewis***	0.0	0.0	4.2	4.2	-57	7
Honeywell International	David Cote	1.8	10.6	0.8	13.2	-57	24
Fastenal	Willard Oberton	0.5	0.5	0.0	0.9	-56	22
Intuitive Surgical	Lonnie Smith***	0.9	3.3	0.0	4.2	-56	139
Marshall & Ilsley	Mark Furlong	0.9	0.4	0.4	1.7	-52	-60
Office Depot	Steve Odland	2.6	0.7	0.1	3.4	-46	116
Nucor	Daniel DiMicco	0.8	2.1	0.0	2.9	-43	4

*Salary and bonuses include nonequity incentive compensation; all other includes pension contributions; data for Nucor collected from preliminary SEC filing; numbers may not add up due to rounding
**Became co-CEO in mid 2008 ***No longer serving as CEO

PHOTOGRAPH BY ANN SUMMA/TIME LIFE PICTURES/GETTY IMAGES; CHARTS BY STANFORD KAY

tion until Citi returns to profitability. Former Bank of America CEO Kenneth D. Lewis also received no salary, bonus, or equity compensation in 2009.

Taking a very different approach, the compensation committee at Wells Fargo last August upped chairman and CEO John G. Stumpf's base salary to $5.6 million, more than five times his 2008 salary. All but $900,000 of that compensation was in company shares. They vested as they were paid out in regular paychecks, making his total 2009 compensation $21.3 million and giving him a 136% boost over the previous year. Melissa K. Murray, a Wells Fargo spokeswoman, said Stumpf received the salary increase because the company was unable to "reward him appropriately" in other pay categories due to TARP-related restrictions.





John Stumpf
WELLS FARGO
His pay package rose 136%, to $21 million in 2009. He made more than the other bank CEOs on the list.

Many companies cut executive pay simply because of poor economic conditions. Compensation committees at Motorola and printer maker Lexmark reduced compensation in part because of challenges in their industries. David M. Cote, Honeywell International's CEO, requested that he not be awarded a bonus in 2009. Directors granted his wish, and as a result Cote took a 57% cut in total pay. At $44, Honeywell's stock remains 29% below its May 2008 high.

Aside from the cuts, the notable takeaway from the analysis is the tilt toward cash and away from compensation that is pegged to a company's long-term performance. Along with the 30% decrease in stock options, the CEOs of the 81 companies saw the value of their stock awards cut by 12%. The discrepancy in those two numbers is an early indication that compensation committees wanted to stick with safer bets when structuring pay packages. Stock awards pay off, albeit with diminished returns, even when a company's stock price stagnates. For options to pay off, prices must climb.

Of course cash is safer than either choice, especially when economic times are tough. In 2008 and the first part of 2009, as boards negotiated with CEOs and set executive compensa-

BIGGEST INCREASES IN 2009 CEO PAY

Among 81 large companies, in millions*

COMPANY	CEO	SALARY AND BONUSES	STOCK AND OPTION AWARDS	ALL OTHER	TOTAL COMPENSATION	CHANGE IN PAY FROM 2008	STOCK TOTAL RETURN IN 2009
Capital One Financial	Richard Fairbank	$0.0	$6.0	$0.1	$6.1	8,807%	24%
Wells Fargo	John Stumpf	5.6	13.1	2.7	21.3	136	-6
AT&T	Randall Stephenson	7.3	12.1	9.9	29.2	85	5
Coca-Cola Enterprises	John Brock	4.7	9.5	1.4	15.6	71	80
Fifth Third Bancorp	Kevin Kabat	2.1	3.0	0.1	5.2	56	19
Valero Energy	William Klesse	1.5	9.2	1.0	11.7	50	-20
Sherwin-Williams	Christopher Connor	3.0	4.1	0.5	7.5	48	6
PNC Financial Services	James Rohr	2.8	11.9	3.4	18.0	47	10
Ameriprise Financial	James Cracchiolo	8.6	9.1	1.1	18.8	47	70
Whirlpool	Jeffrey Fettig	4.8	5.9	1.8	12.5	42	103
Occidental Petroleum	Ray Irani	4.9	24.8	1.7	31.4	39	38
New York Times	Janet Robinson	3.2	1.6	1.4	6.3	32	69

*Salary and bonuses include nonequity incentive compensation; all other includes pension contributions; data for Nucor collected from preliminary SEC filing; numbers may not add up due to rounding
Data: Bloomberg, Securities & Exchange Commission

BRENDAN SMIALOWSKI/BLOOMBERG



[redacted]



Vikram Pandit
CITIGROUP
In January 2009 he earned $125,000, and Citi stock dropped 47%. A month later he said he'd take $1 in annual pay.

[redacted]

tion, stocks were tumbling and the market was volatile. The future value of options and stock awards was hard to predict. That may be one reason cash compensation increased at 43 of the 81 companies analyzed and that CEO salaries were up 8.9%. "In times of recession when the economy is reeling, the most stable form of pay isn't stocks, it's cash," says Sam Pizzigati, of the Institute for Policy Studies, who has written about compensation and shareholder activism. "In rough times the surest thing is cash, and that's what they went for."

Steven Hall, a compensation consultant, pointed out that stock options have lost value and don't necessarily have as much "holding power on executives." He says some companies felt they had to offer CEOs more cash so that competitors didn't "steal their talent away."

Among the compensation packages analyzed, the average CEO cash bonus, including nonequity incentives, was $2.1 million, up 7.9% over the previous year. One reason the percentage went up was that some companies didn't give cash bonuses at all in 2008, a dismal year for most. Nine CEOs took home cash bonuses in 2009 after not getting them the year before. Among the big rebounders were Dow Chemical's Andrew N. Liveris, who was awarded $4.5 million, and Aflac's Daniel P. Amos, who received $4.1 million.

Some of the increase in cash bonuses also may be due to lowered performance targets set by boards. Frank Glassner, CEO of Veritas Executive Compensation Consultants, says performance goals for long-term awards have been reduced, giving CEOs a better chance to hit their marks. "Companies haven't raised the bridge, they've just lowered the river," he says. Glassmaker Corning, in its proxy, said it had altered performance metrics "in order to alleviate any unintended shortfalls or windfalls in actual bonus payouts." The company cited the "great uncertainty in accurately forecasting the impact of the global recession in early 2009." Earnings per share for 2009 fell 12% last year. CEO Wendell P. Weeks was granted an annual incentive bonus of $4.8 million, up from $301,584 in 2008.

Finally, some companies were worried about what would happen if the market made a dramatic rebound from its 2009 lows. Kenneth Raskin, an attorney at the law firm White & Case, who represents CEOs in pay negotiations, says that when 2009 pay packages were being negotiated, the stock market was depressed, and some boards didn't want to give out large options awards because of the potential for large gains that would later make the awards look excessive. Ira T. Kay, an executive pay consultant, adds that some CEOs had similar worries. "CEOs didn't want the stock price to rise dramatically and in a year [for them to] seem far too greedy," he says.

A fast-growing compensation category in 2009 was pen-



[redacted]



Ray Irani
OCCIDENTAL PETROLEUM
His $31 million pay package, up 39% from 2008, was the biggest among the 81 CEOs.

[redacted]

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Randall Stephenson
AT&T
His pay is up 85%, to $29.2 million. In 2008 he received a lower salary and was not awarded a bonus.

sions. Company contributions to CEO pension plans gained an average of 15.4%, with the executives on our list receiving about $1.3 million on average. One reason: The 8.3% rise in salary and bonuses drove up the current value of what companies promise to pay CEOs in retirement, typically calculated as a percentage of their annual income. AT&T CEO Randall Stephenson received a $9 million contribution to his pension plan, the biggest of those surveyed. Under this plan, Stephenson will get 60% of the salary and bonus that he has earned, calculated by averaging the value of the highest 3 years within the last 10 years of his tenure. An outside spokesman for AT&T, McCall Butler, said Stephenson's pension gain was "an actuarial value, not part of his actual taxable income" in 2009.

Carole Lovell, president of an AT&T retiree association, said in a letter to shareholders last April that "AT&T's executive compensation policies continue to exhibit all the worst excesses and abuses." She was writing in support of a shareholders' say-on-pay resolution, which didn't win majority approval at the company's annual meeting that month.

The category that took the second-biggest hit after options was the "all other compensation" column of the company proxies, which dropped 23%. That category includes the fun stuff—perks such as private planes, security details, and country club memberships—that sometimes gets CEOs into public relations hot water. Lincoln National CEO Dennis R. Glass saw this pay category drop to $308,463 last year from $2.26 million in 2008. His perks were limited to a $16,600 matching charitable contribution and included nothing for personal use of aircraft, which was reported as $82,901 the year before. "These kind of perks just aren't worth it," says David E. Gordon of Frederic W. Cook & Co., a compensation consultancy. "They are a small fraction of overall compensation but have the ability to get 50% of the attention."

Certainly public pressure played a role in forcing executive pay cuts. Last year shareholder activists on boards such as AT&T, Apple, and Pfizer campaigned for say-on-pay resolutions. (Shareholders succeeded at Apple and Pfizer, and didn't at AT&T.) While typically nonbinding, they allow shareholders a say on whether or not pay packages are too fat. RiskMetrics, a governance consulting firm, has counted 180 pending resolutions concerning executive compensation. That's down from 230 as of the same time last year, says Carol Bowie of RiskMetrics, but well ahead of the level five years ago.

Tim White, a partner with executive recruiter Kaye/Bassman, ties shareholder dismay on pay to the economic downturn. "In difficult times, there is always a clamoring for the fat cats to make less money," he says. Some of that uproar soon may be tempered. His prediction as the economy improves? Executive compensation will go right back up. |BW|





John P. Surma
UNITED STATES STEEL
His $3.6 million in compensation was 75% less than he received in 2008. His company's stock returned 50% last year.

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Kentucky's Calipari is college basketball's highest-paid coach

YE$!

NO ONE MAKES MORE MONEY FROM MARCH MADNESS THAN BIG-TIME BASKETBALL COACHES. ARE THEY WORTH THEIR NET PROFITS?



By Jason Zengerle

Photograph by Charles Bertram

On the night of Apr. 5, when the coach of college basketball's newly crowned champion climbs a ladder in Indianapolis to cut down the nets, the moment will be freighted with emotion—and money. March Madness, after all, isn't just a basketball tournament; it's a cash cow. CBS last year charged nearly $1.2 million for a 30-second spot during the national championship game, the highest ad rate

(CALIPARI) *LEXINGTON HERALD-LEADER*/ZUMA PRESS; (BASKETBALL) KIM STEELE/GETTY IMAGES

John Calipari
UNIVERSITY OF KENTUCKY



$3.7 MILLION / YEAR

Receives $650,000 bonus if Kentucky wins the NCAA tournament

for any sporting event not called the SuperBowl. Even the aforementioned ladder is monetized: For the third year running, the Werner Ladder Co. has paid the National Collegiate Athletic Assn. and CBS an undisclosed sum—and built a special 9-foot model—in order to be "The Official Ladder of the NCAA Basketball Championships."

On an individual level, no one gains more from March Madness than the coach standing atop that ladder. It's a good bet his contract contains a hefty bonus clause for winning the title. Should the University of Kentucky win it all, its coach, John Calipari, will receive an additional $650,000 on top of his $3.7 million in guaranteed compensation this year. And winning the NCAA tournament almost always means a new, more lucrative contract for a coach, as well. After the University of Kansas won the national title in 2008, it tore up Bill Self's $1.6 million-a-year contract, which had three years remaining, and gave him a new 10-year, $30 million deal.

Even the coach of the losing team in the finals can reap an irrational profit. In 2004, runner-up Georgia Tech rewarded Paul Hewitt with a new six-year contract that bumped his pay past $1 million a year. More impressively, it includes a provision that calls for the term of the contract always to remain at six years. That means should Georgia Tech ever want to fire Hewitt—something many Yellow Jackets fans would like, since Hewitt hasn't been within sniffing distance of the Final Four since then—it will have to pay him nearly $7 million in severance. (Hewitt has recently been in discussions about moving to St. John's University.)

If, as the saying goes, the NBA is a players' game, then college hoops belongs to the coaches. With the best college players staying in school for only a year or two, it is the grown men stalking the sidelines who supply the identity and (relative) continuity of college basketball. Fans create cheers around the coaches' names, the alumni clamor for them to attend their gatherings, and the television cameras focus on their contorted faces throughout the game. But their power is much more than symbolic. The peculiarities of the labor market give them huge financial leverage. Unlike the players, who according to NCAA rules must sit out a year if they transfer to another school, coaches can, and do, change jobs pretty much at will. Even more important, because the NCAA remains wedded to the romantic imagery of amateur "student athletes," the coaches are March Madness' only officially paid contestants. So even in today's economic climate—with schools facing budget cuts and shriveled endowments—college coaches remain proudly impervious to recessionary pressures. "Someone asked me, 'When are universities going to quit paying coaches these outlandish salaries?' " says University of Kentucky President Lee Todd. "And I answered, 'When people turn off their televisions and don't want to watch college basketball.' "

NIKE'S EMOLUMENTS

Before 1979—the momentous year in which Larry Bird and Magic Johnson faced off in the NCAA finals, ESPN was born, and the Big East Conference was formed—college basketball was small-time. "Coaches would get a one-page 'letter of appointment' saying, 'Here's your salary, you're here for this year, good luck,' " recalls Robert Ades, a lawyer who represents top coaches, including Syracuse University's Jim Boeheim and University of Maryland's Gary Williams. "But after 1979, you had 10-page appointment agreements, 20-page endorsement agreements, and 10-page media agreements."

The biggest boost to coaches' paychecks initially came from the shoe companies, particularly Nike. In the late '70s, a basketball promoter named Sonny Vaccaro persuaded Nike, then a fledgling company focused on runners, to break into the basketball market by paying coaches to outfit their players in Nike gear. The first payments topped out at around $10,000. By the mid-'80s, after Nike's annual basketball shoe sales grew from $7 million to $400 million, the company was giving coaches such as Georgetown University's John Thompson $200,000 a year. "Nike was paying them more than the schools," says Vaccaro.

MOST OF CALIPARI'S $3.7 MIL PER YEAR COMES FROM UK'S DEALS WITH NIKE AND SPORTS MARKETER IMG



In the 1990s, Nike and other shoe companies mostly stopped paying coaches directly and signed "all-school agreements," in which the company cuts a check to the school in exchange for all its teams wearing its gear and for other considerations (such as signs in stadiums and arenas) that coaches don't control. The universities then disperse this money to their coaching staffs, with the major portions of it going to their football and basketball

(TOP) CORBIS

Tom Izzo
MICHIGAN STATE



$2.59 MILLION
Also gets 5-year position in the athletic dept. after retirement—at $200,000 per annum

Bruce Pearl
UNIVERSITY OF TENNESSEE



$2.4 MILLION
Includes a $500,000 "longevity bonus" for staying five years

Frank Martin
KANSAS STATE UNIVERSITY



$760,000
New five-year contract will bump his pay to an average of $1.55 million a season

Ben Jacobson
UNIV. OF NOTHERN IOWA



$290,000
Team's NCAA run all but guarantees a hefty raise or a new job

(L TO R) AL GOLDIS/AP IMAGES; DAVE MARTIN/AP PHOTO; SCOTT SEWELL/CAL SPORT MEDIA/SIPA PRESS; TONY GUTIERREZ/AP PHOTO

coaches. In addition to the ample proceeds from broadcast deals and other corporate sponsorships, these funds account for the bulk of coaches' compensation today.

Kentucky's Calipari is currently the highest-paid coach in college basketball. He has an eight-year, $31.65 million deal, but of the $3.7 million he's guaranteed to make in 2010, only $400,000 is formal salary. The rest comes from what his contract calls "University Agreements," which include Kentucky's deals with Nike and the sports marketing giant IMG (which runs the network that carries Calipari's radio and television shows). Many coaches are explicitly paid for appearances; Jim Calhoun, coach at the University of Connecticut, made $1.6 million this year in a deal that compensates him for, among other things, attending golf outings, banquets, and the team's annual visit to the Connecticut State Capitol.

SWEATER RIGHTS

Beyond their mammoth contracts, coaches have shown a gift for entrepreneurialism. When Ohio State University hired Jim O'Brien as its basketball coach in 1997, he received $200,000 from the university's all-school deal with Nike. O'Brien then cut his own separate deal with another company to supply his team with basketballs. "Ohio State said, 'You can't do that,'" recalls Ades, who represented O'Brien. "I said, 'You didn't say anything about the ball.' So then they changed that. They had to buy him out. It cost them money to learn that." Bob Knight, while the coach at Texas Tech, sold "sweater rights" to O'Reilly Auto Parts, which slapped its logo on the black sweaters Knight wore during games.

Then there are the summer basketball camps, which range from the John Calipari Basketball School, at which children ages 7 to 18 pay $415 for the opportunity to have Kentucky's coach tell them to bend their knees on their foul shots, to Duke Coach Mike Krzyzewski's "K Academy," where adults fork over $10,000 to spend five days playing basketball and learning "team-building techniques."

Krzyzewski's team-building lessons are even in demand away from the basketball court. He's a regular presence on the corporate speaking circuit, charging $100,000 a pop, and has served as a pitchman for American Express, boasting in the company's commercials: "I look at myself as a leader who just happens to coach basketball." Of the five books he has authored, only two are about hoops; the other three are about business.

So what do the institutions of higher learning that pay these coaches so much get out of the deal? Reliable data for the return on investment of a big-time college basketball team is difficult to obtain. Under the Equity in Athletics Disclosure Act (EADA), each school is required to submit annual revenue and expense figures to the U.S. Education Dept., but there is no uniform accounting standard, and the figures are all over the map. For instance, according to Duke's most recent EADA filing, its basketball team lost more than $2 million in 2008. That's only because the university's accountants didn't credit a substantial amount of income—like $9 million in booster club donations for the opportunity to buy Duke basketball season tickets—to the hoopsters.

At schools with on-campus arenas that hold more than 20,000, such as the University of North Carolina, ticket sales, concessions, and sponsorship deals bring in substantial revenues. Wachovia pays UNC more than $1 million a year to put its logo on a courtside table and elsewhere at UNC sporting events. Booster clubs, like Duke's, typically kick in millions for prime seats. And the better a school's performance, the more merchandise it sells: When Kansas won the national championship in 2008, its licensing revenue exploded to $2.5 million, $1.5 million more than the previous year's.

The presidents of big-time basketball schools are quick to point out that the money their teams generate covers expenses for so-called nonrevenue sports, such as volleyball, water polo, and wrestling. At a handful of schools, the money from basketball and football even overflows the athletic department's coffers and trickles down to the rest of the university. "Each year the athletic department gives us $1.7 million in cash for non-

Mike Krzyzewski
DUKE UNIVERSITY



$3.6 MILLION

Figure is from 2008. On top of his hoops income, he has written three business books

athletic scholarships," says the University of Kentucky's Todd.

These presidents also point to other, less tangible benefits. "One of the most effective ways to market your university nationally is to have a really quality athletic program," says David Schmidly, the president of the University of New Mexico, whose basketball team set a school record for wins this year. "It helps recruit faculty, students, and donors. It helps with the image of the whole university." That's why, when Schmidly became New Mexico's president three years ago, one of his first orders of business was to hire a basketball coach who could build a "nationally competitive program"—something he'd done when, as the president of Texas Tech, he hired Bobby Knight. With the promise of $1 million in annual compensation—not to mention $60 million of renovations to the school's arena that will make it, Schmidly boasts, "the best basketball facility west of the Mississippi River"—Schmidly lured one of Knight's former players, Steve Alford, to coach New Mexico.

The fact that Alford now makes almost twice as much as the man who hired him doesn't bother Schmidly. "It's all market driven," he says. "Steve's probably the only million-dollar coach in New Mexico, and a lot of people have expressed concern about that, but you have to look at what you get. It's a competitive industry, and if you want a good-quality coach, you've got to pay for it."

OPPORTUNITY FOR THE LITTLE GUYS

For raw earning potential, basketball is far less lucrative than football. According to the University of Texas's statistics, its football team turned a $65 million profit in 2008, making it a much better business than most professional football operations. But the team's annual expenses—including scholarships for 85 players, a $5.1 million annual salary for its head coach, and $900,000 a year for his top assistant—run to more than $20 million, a level of investment only a big state school like Texas can typically afford. By contrast, the top-tier basketball teams are lucky to clear $10 million. But the barriers to entry for hoops—13 scholarships, one well-paid coach, and a gym are the basic components—are surmountable for less well-heeled schools, like Butler, Gonzaga, and Xavier, that want to make a name for themselves as March Madness participants. On the basketball floor at least, they can hold their own with the giants.

For a school that fields a competitive mid-major Division 1 team and hopes to crack the NCAA tournament every few years, the going rate for an experienced coach is roughly $300,000. A nonstar coach in the Atlantic Coast Conference, in which Duke and North Carolina play, costs more than double that. Success brings rapid inflation. If a coach puts together a string of tournament wins, it can quickly become unclear who works for whom. The top coaches tend to transfer the whole value of their programs onto themselves. "The cream-of-the-crop players tend to be one-and-done, so they're picking schools by coaches as much as anything," says Craig Fenech, a sports agent who has represented coaches and players. "The coaches are game-changers."

For all its success, Duke basketball without Mike Krzyzewski would not necessarily remain a national power, and the university understands that. So when the Los Angeles Lakers tried to hire Krzyzewski six years ago, Duke President Richard Brodhead, once a literature professor at Yale, locked arms with students at a rally outside the school's basketball arena to form a big, human "K" and chanted, "Coach K, please stay!" Oh, and he gave the coach a lifetime contract. Brodhead knew that no matter what else he did at Duke, if Krzyzewski left, he'd always be known as The President Who Let Coach K Get Away."

WHEN THE LAKERS MADE A RUN AT COACH K, DUKE HELD A RALLY TO BEG HIM TO STAY—AND GAVE HIM A LIFETIME CONTRACT



That may be the biggest reason why—in the midst of hiring freezes and faculty furloughs—university presidents are still shelling out the big bucks for basketball coaches: They fear the consequences of losing. Last year, Kentucky's Todd fired Billy Gillispie after only two seasons on the job and paid a king's ransom to land Calipari. A UK alum himself, who as a Massachusetts Institute of Technology grad student used to drive to a hill outside Boston so he could pick up the signal from a Louisville AM station that broadcast Wildcat games, Todd knows how passionate Kentucky basketball fans can be. And the fact that Kentucky has not been to a Final Four in his nine-year tenure as the school's president weighs on him personally—and professionally. "My job is a whole lot easier, and I'm a much better president," Todd says, "when we're winning ball games." |BW|

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ECONOMICS AND POLICY

Obamacare's Cost Scalpel

How does the health-care overhaul propose to control spending? By evaluating treatments through "comparative effectiveness research"

By Alex Nussbaum, Meg Tirrell, Pat Wechsler, and Tom Randall

One often-heard criticism of the health-care reform legislation that President Barack Obama has now signed into law is that it won't do enough to rein in the cost of treatment. U.S. medical spending has soared to $2.5 trillion per year (a price tag that has more than doubled in 15 years) and represents 18% of the nation's gross domestic product. Can Obamacare begin to cope with that?

The answer is a qualified yes. Tucked inside the 2,400-page bill is an item (it's right there on page 1,617) that has generated far less attention and political heat than other parts of the White House's plan to expand medical coverage to 32 million uninsured Americans. The measure requires the U.S. to put aside $500 million or more a year for something called "comparative effectiveness research," an ungainly name for a process Obama hopes will reduce costs. The studies, designed to show which drugs, devices, and medical treatments work best, could have an enormous impact on the delivery of health care in the years ahead, scrutinizing everything from cholesterol drugs and heart stents to hospital procedures.

By using statistics-driven research methods, its backers say, comparative effectiveness promises to bring scientific rigor to medical decision-making that is too often influenced by tradition and marketing. As such, the research is one of the few measures in the new law that has any chance of flattening America's medical cost curve, according to Boston-based health-care analyst John Sullivan of Leerink Swann.

That also means that comparative effectiveness may be "a headwind for the health-care industry," Sullivan says. "If research shows that less complex and maybe less expensive products and therapies work just as well, that is not good news" for many companies. On top of that, the new health-care reform law tightens restrictions on insurers and requires that most Americans be covered.

Comparative effectiveness is not the only tool in the law designed to pry savings out of the system, says Peter Orszag, Obama's budget director. The legislation also tests new payment systems for doctors, penalizes hospitals for high readmission rates, and creates an independent commission to evaluate which treatments Medicare should pay for, he says. "I don't think there's any one piece that, by itself, is the end-all, be-all" for slowing the growth in medical expenses, Orszag says. "Together, they work to move toward a higher-quality, lower-cost system over time."

Orszag, a lanky, high-octane economist who trained at Princeton University and the London School of Economics, has been a leading evangelist for comparative effectiveness research. As a scholar at the Brookings Institution in Washington, Orszag was perplexed that so much attention was being paid to the rising cost of Social Security, even though health care represented a far larger share of the nation's economy. Orszag eventually discovered the Dartmouth Atlas of Health Care, a national study on the variations in how medical resources are distributed in the U.S.

"HUGE EFFICIENCIES"

That research suggested that $700 billion in annual savings could be achieved by eliminating wide disparities in the cost of similar procedures, especially those in which pricier options don't produce better outcomes. "Huge efficiencies could be gained if we change the way we practice medicine," Orszag said in a May 2009 interview, as he lobbied for the creation of a government institute to gather the evidence.

Republican critics, meanwhile, argued throughout the yearlong overhaul struggle that the concept was a stealth effort to deny health care to people who need it. Orszag

NADAV KANDER ON BEHALF OF INSTITUTE



Orszag has led Obama's push for comparative effectiveness research

prevailed. Last year, Congress approved $1.1 billion in stimulus funding for effectiveness research. The new legislation creates a nonprofit Patient-Centered Outcomes Research Institute and charges it with setting a national agenda for the studies, as well as providing more money and disseminating results.

The institute will be run by a 19-member board of governors that must include three representatives of drug, device, and diagnostic-testing companies. The U.S. Comptroller General, a Presidential appointee, must name the board within six months.

The health-care law focuses on studies that assess effectiveness rather than compare cost. It also bars Medicare, the government insurer for the elderly, from using the research as the sole grounds for denying reimbursement for medical products or procedures.



Commonly used treatments, such as heart stents, will be scrutinized first

Still, "the savings can be substantial if you're drawing a clinical study conclusion that a generic drug works as well as a branded drug," says Leerink Swann's Sullivan, who suggests that therapies used by large numbers of people are likely to be researchers' first targets. That means that Pfizer's cholesterol blockbuster, Lipitor, could be in the crosshairs, Sullivan says, along with anti-inflammatory drugs such as Johnson & Johnson's Remicade, and heart stents made by Medtronic and Boston Scientific.

The research may spur consolidation among health-care companies, said Jeffrey C. Lerner, chief executive officer at the ECRI Institute, which does comparative effectiveness research for government and hospitals. Smaller manufacturers may not have the resources to rebut studies questioning their products' value. A 2005 study of antipsychotic medications shows that the most effective treatment doesn't always prevail in the marketplace, says Robert Rosenheck, a psychiatry professor at Yale University School of Medicine in New Haven, Conn. The U.S.-backed study found a 50-year-old drug that cost about $2.50 a day worked as well as newer medicines that can cost eight times as much. Sales of the next-generation antipsychotics, led by AstraZeneca's Seroquel, Eli Lilly's Zyprexa, and Johnson & Johnson's Risperdal, still jumped 43% in four years to $14.75 billion in 2009, according to IMS Health, a collector of prescription-drug data based in Norwalk, Conn. "The overwhelming weight of very aggressive marketing for 15 years shapes attitudes in ways that aren't likely to be changed by research," says Rosenheck, author of two antipsychotic comparison studies.

Comparative studies changed practices in breast cancer, where doctors ended the routine removal of entire breasts after studies found less drastic operations were just as effective, Rosenheck says. "Those are mostly [treatments] where there was no private corporation actively marketing its perspective."

RESEARCH MAY NOT BE ENOUGH TO CHANGE ATTITUDES SHAPED BY YEARS OF AGGRESSIVE MARKETING

Funding for comparative effectiveness in the health law is tied to Medicare's trust fund and a new tax on insurers, which should help insulate the research from politics, says Daniel Mendelson, a former official in Bill Clinton's Office of Management & Budget who is now CEO of Avalere Health, a Washington consulting firm. Companies need to realize that comparative research is now "a permanent part of the dialogue," he says.

Drugmakers, led by Pfizer, support the effort as "an important solution for better quality and ultimately better value in health care," says Randy Burkholder, an associate vice-president at PhRMA, the industry's trade group. Device companies agree, says David Nexon, an executive vice-president at trade group AdvaMed. The industry favored the legislation because it focuses on clinical effectiveness, rather than cost and because manufacturers will be part of the decision-making, he says. Device-makers hope it can speed widespread use of technologies proven better than existing treatments, Nexon says.

"It takes about 17 years until a new technology is fully accepted as the dominant practice even for something that's new and better," he says. "If you've got something that's really superior, having these studies validate that can really speed up the adoption."

For doctors, the research results will run up against years of tradition, says Devon Herrick, senior fellow at the nonprofit National Center for Policy Analysis in Dallas. Doctors tend not to think about the cost of the drugs they're prescribing, Herrick says. "Quite often what happens is you go to your doctor, they pull a free sample out of the pill cabinet because people like getting something for free, but they don't know it's the highest-price drug that the companies want to promote," he says. Changing that mindset is what comparative effectiveness is all about. |BW|

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NICHOLAS EVELEIGH

STRATEGY & COMPETITION

Attention, Shoppers: This Patent Expired

Products marked with out-of-date claims are provoking a wave of lawsuits from consumers

By Susan Decker

What do Procter & Gamble's Oral-B toothbrushes have in common with Kimberly-Clark's Depends Underwear for women and the painkiller Advil from Pfizer? These products, along with Quigley's Cold-Eeze lozenges and Prevacid, a heartburn medicine from Novartis, are entangled in dozens of patent lawsuits filed in federal courts in Chicago, New York, and other cities. Nobody's complaining about infringement. The problem is that the patents have expired, say organizations and individuals who are suing.

The suits stem, oddly enough, from a U.S. appeals court ruling in December involving improper patent markings on construction stilts on a job site. The ruling said product vendors could face a federal penalty of up to $500 for every item falsely marked—and consumers who file such suits and win may split the damages with the U.S. government. "There's just been an explosion of these cases, says Jason C. White of the Howrey law firm in Chicago, who has represented companies in such suits.

At work is a century-old law, last amended in 1952, that lets individuals sue on behalf of the government. The law was designed to deter manufacturers from inaccurately claiming their products are protected by patents, which can squelch competition and confer an unfair marketing advantage. There's no justification for the erroneous markings, says Daniel B. Ravicher, executive director of the Public Patent Foundation in New York, a nonprofit that brought the suits against Quigley and Novartis. "No one is holding a gun to these companies' heads and forcing them to [make] false statements."

HOW TO PLAY IT 76

Legal catnip: Plaintiffs say all these products are off-patent

Plaintiffs who win could be well rewarded—at least in theory. In the Advil suit, for example, Pfizer would have to fork over $500 for each box sold if it were hit with the maximum penalty. But don't expect windfall judgements, says Ravicher. Judges have a lot of discretion. In cases with a large number of products, he says, they could award "a gazillionth of a penny" on each item.

That's assuming the suits make it to trial. Last May a federal judge in New York threw out a suit against Brooks Brothers over bow ties marked with patent numbers that expired in the 1950s. He found that the New Jersey patent lawyer who filed the complaints wasn't hurt by the false markings and any harm to competition was theoretical. Now Congress is considering requiring that only those who suffer a "competitive injury" be allowed to sue. That means most consumer suits—many filed by a small number of individuals—would be banned.

Chicago lawyer White says companies have a valid argument. They're required to put relevant patent numbers on products if they want to collect damages for past infringement in a lawsuit. If they fail to remove the markings through simple oversight, he says, "How does that equate to purposeful intent to deceive the public?" |BW|
—With Andrew M. Harris in Chicago

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STRATEGY & COMPETITION

A Three-Way Food Fight In Brazil

In Latin America's largest market, Wal-Mart is spending big to overtake Carrefour and a local rival

By Ladka Bauerova, Chris Burritt, and Joao Oliveira

Maria do Socorro Brito Lyra never leaves her São Paulo home to go shopping without her supermarket circulars. Each of the nation's three biggest grocers promises to match the lowest price offered by a competitor if shoppers come armed with a rival's flyer. "I always pay the lowest price," declares the 34-year-old teacher, waving a fistful of flyers as she stands at a Wal-Mart Stores checkout.

In this most open of the large emerging economies, the world's two biggest supermarket chains and a homegrown competitor are battling for dominance. Leading the field is Companhia Brasileira de Distribuicão Grupo Pão de Açúcar, with revenues of $13 billion in 2009. Close behind is France's Carrefour, with sales last year of $12.6 billion. In third place, but making a big push, is the world's No. 1 retailer, Wal-Mart Stores, which operates under several names in Brazil. It racked up $9.5 billion in sales in Brazil last year.



Bargain hunting: A shopper at a Wal-Mart Todo Dia supermarket in São Paulo

PAULO FRIDMAN/BLOOMBERG

"WE HAVE A VERY, VERY CLEAR PLAN TO WIN. WE ARE INVESTING HEAVILY TO HAVE A MORE SOLID AND PERSUASIVE PRESENCE"

All three plan to invest big in Brazil in coming years. As its middle class expands, annual spending on food is expected to rise 50% over the next five years, to $406 billion, says Carlos Hernandez, a Madrid-based analyst at consultant Planet Retail. Among the emerging nations known as the BRICs, Brazil offers fewer barriers to business than Russia, India, and China. India bans foreign stores that sell multiple brands, and Russia limits expansion by retailers. China is attractive because of its rapid economic growth, expected to be 8% in 2010, vs. 5.8% in Brazil. However, "Brazil is more developed in terms of infrastructure and wealth creation," says Justin Scarborough, a retail analyst at Royal Bank of Scotland in London. "Consumers are used to shopping in hypermarkets, whereas retail in China is more traditional."

Already No. 1 in Mexico, Wal-Mart aims to overtake Carrefour to become No. 2 or No. 1 in Latin America's largest market. The Bentonville (Ark.) retailer plans to spend $1.2 billion this year to open 110 new stores in Brazil, on top of the 436 it now operates. It may also scout out an acquisition, says Héctor Núñez, president of Wal-Mart Brazil. "We have a very, very clear plan to win here in Brazil," he says. "We are investing heavily to start having a much more solid and persuasive presence."

Wal-Mart is opening the cash spigot at a time when Carrefour is contending with the recession in Europe, which accounts for 80% of its revenues. Annual sales growth for the Paris-based chain at home has averaged less than 1% over the last 10 years. To defend its No. 2 position in Brazil, Carrefour is planning to spend $1.4 billion over the next two years. The goal: to add 70 stores and double Brazil's share of Carrefour's overall sales to 20% by 2015. Pão de Açúcar, which is 34% owned by French supermarket chain Casino, says it will invest $2.8 billion to add 300 stores to its 1,080-store chain by 2012.

As the race for shoppers intensifies, Carrefour may have a hard time staving off Wal-Mart's assault. The U.S. company is outspending its rival in Brazil, yet its investment amounts to less than 10% of its overall capital budget. Carrefour is pouring 20% of its budget into Latin America. Predicts James Monro, an analyst at Standard & Poor's in London: If Wal-Mart stays on track, it "will inevitably take over the region and become No. 1." |BW|



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STRATEGY & COMPETITION

And Now, Gastric Surgery for Kids

Allergan wants to market its Lap-Band implants for younger obese patients, but some doctors are balking

By Elizabeth Lopatto

In January 2009, 18-year-old Ronalis Naveo weighed 331 pounds and was at high risk for type 2 diabetes. Dieting didn't help. So doctors recommended a procedure in which a slender, hollow belt of silicone was inserted through small cuts in his belly, looped around his stomach, and filled with saline solution. This Lap-Band, made by Allergan, left him feeling sated even as his food consumption plummeted.

Today, Naveo is 89 lb. lighter and no longer prediabetic. "When I lost my first 30 lb., I walked up the stairs and was like, 'Mom, I can breathe,'" says Naveo. "That was just, wow."



Doctors performed weight-loss surgery of various types on nearly 220,000 people over the age of 18 in the U.S. last year, according to the American Society for Metabolic & Bariatric Surgery, an organization of doctors who carry out the procedures. Many were fitted with gastric bands such as Allergan's, which brought the Irvine (Calif.) company close to $258 million in sales in 2009. Now Allergan, best known for Botox, is asking U.S. regulators to approve its Lap-Bands for teens as young as 14. As part of that push, the company is moving ahead with studies in adolescents.

While the U.S. Food & Drug Administration has approved gastric bands only for adults, doctors may perform the procedure on younger patients. Yet, without regulatory approval, Allergan can't market Lap-Bands for that group. A nod from the FDA could open an avenue to as many as 2 million new customers, says Christine Ren-Fielding, a surgeon at New York University's Langone Weight Management Program. That would be a big boost for Allergan, which has about 70% of the market, according to Leerink Swann analyst Gary Nachman, and for Johnson & Johnson, which makes a gastric band called Realize. Sanford C. Bernstein analyst Aaron Gal says approval for children could increase Lap-Band sales by as much as $20 million a year.

Are Lap-Bands good for kids? Data is scarce. In one study by Australian researchers, older teens fitted with Lap-Bands lost 28% of their total body weight, on average. In comparison, a diet and exercise group lost just 3.1%, according to the study, which was funded by Australia's National Health & Medical Research Council. Allergan supplied the Lap-Bands. The company is now awaiting results from its own trial, begun in February 2006, involving about 150 obese adolescents ages 14 to 17. Allergan declined to comment on the research. In an e-mail, a spokeswoman said the company "recognized the potential benefit of [the] Lap-Band to a greater patient population."

Young or old, patients face risks that include blood clots, infections, and gallstones. Edward Livingston, a surgeon at the University of Texas Southwestern Medical Center in Dallas, raises another concern. No data exist showing gastric bands are effective in the long term, either in adults or kids.



Naveo lost 89 lb. after surgeons inserted a gastric band in his belly in January 2009

Many of his patients regain weight 5 to 10 years after surgery, says Livingston, who has performed bariatric surgeries on adults for 17 years. The problem, he says, "is that you're treating a psychological disease with a knife." In addition, "you need warnings to counsel parents and patients about lifestyle changes," because even if the procedures cause no harm, the benefits may not stick.

David Ludwig, director of the obesity program at Children's Hospital in Boston, also stresses lifestyle. "Ultimately, we want to create a public health approach that makes surgery unnecessary—less junk food, better school lunch, physical education in school," he says. But until then, "surgery may be the necessary fallback for some of the most extreme cases." |BW|

(TOP TO BOTTOM) RUDY ARCHULETA/REDUX; COURTESY RONALIS NAVEO


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MONEY REPORT

RETAIL RALLY?

Retail sales totaled $710 million in the first two months of 2010, up slightly from a year ago, according to the Commerce Dept. Despite a stubborn unemployment rate, analysts at Standard & Poor's Equity Research wrote on Mar. 15 that many retailers "may be poised for ... significant growth." Such companies as Advance Auto Parts, Wal-Mart Stores, and Dollar General may have "benefitted from a change in consumer behavior brought on by the recession" – such as repairing cars instead of trading them in for new ones. Wall Street analysts upped earnings forecasts for more than 100 U.S. retail stocks in the past month, including J. Crew Group, according to Bloomberg data. For fund investors interested in retail, S&P recommends Fidelity Select Consumer Discretionary and Rydex Retailing. *–Tara Kalwarski*



Shoppers are starting to load up at such stores as this Wal-Mart in Sugar Land, Tex.

MUTUAL FUND CASH

BUYING SPREE

U.S. stock mutual funds are putting money to work: Cash made up 3.6% of the average portfolio's holdings in January, the lowest reading since September 2007. A year earlier, the average was 5.7%. The fact that so much money has already gone into the market could signal slowing market momentum. "It's not a red light," says Parnassus Investments President Jerome Dodson. "But it's a flashing yellow light that the strongest part of the rally is probably over." At 1160 on Mar. 19, the S&P 500 is up about 72% since its March 2009 low. Dodson estimates it will rise 6% to 9% this year, to the 1186 to 1225 range.

One argument for a continued really is the $3 trillion in money market funds. In the week ended Mar. 16, investors yanked $75.6 billion out of money markets, the third-largest one-week withdrawal ever, according to iMoneyNet. While a lot of cash has been poured into bonds, investors could start focusing on stocks instead. *–Lynn Thomasson*



STOCKS

GOOD DAY AT BLACKROCK

On Mar. 17 shares of BlackRock, the world's biggest asset manager, rose 4.9% after Credit Suisse Group analysts raised their rating on the stock to outperform, from neutral. The analysts expect increased investments in the firm's exchange-traded funds and bigger sales outside the U.S. to drive earnings. As a result, they reckon shares could rise to 280, from 224, over the next 12 months. *–Sree Vidya Bhaktavatsalam*

(TOP TO BOTTOM) MICHAEL STRAVATO/POLARIS; GETTY IMAGES

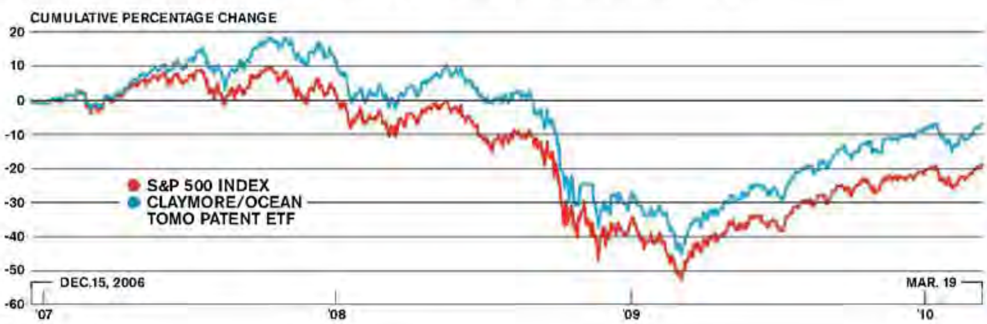
HOW TO PLAY IT | PATENTS



(FROM PAGE 68)

By Tara Kalwarski

The long-term payoff of a patent can be hard to quantify. In industries such as technology and health care, however, many have proved quite profitable. The performance of the Claymore/Ocean Tomo Patent Exchange-Traded Fund, which tracks an index of 300 companies that boast "quality" patent portfolios, has topped the S&P 500 by more than 10 percentage points since its launch in late 2006. Investors looking to profit from patents can invest in this ETF or buy shares of a company like IBM, the top recipient of invention patents in the U.S. in 2009.

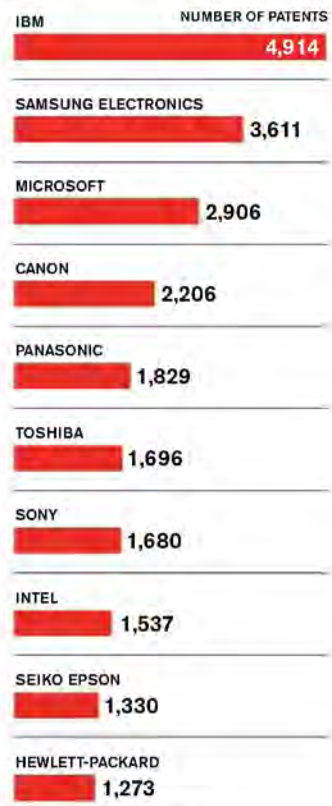


Data: Bloomberg

TOP INNOVATORS

Although a domestic company tops the list, foreign businesses collected more than half of U.S. patents issued for the second year in a row.

TOP RECIPIENTS OF U.S. INVENTION PATENTS IN 2009

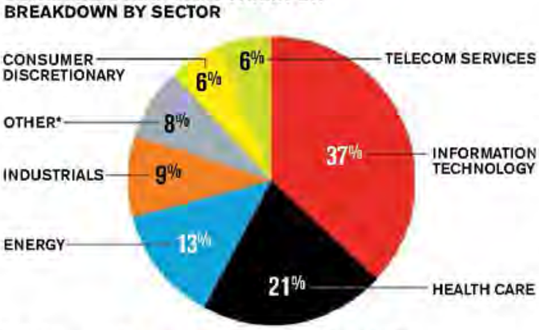


Data: IFI Patent Intelligence

INVENTIVE INDUSTRIES

Tech stocks account for the biggest share of the Claymore/Ocean Tomo Patent ETF

CLAYMORE/OCEAN TOMO PATENT ETF BREAKDOWN BY SECTOR



*Includes materials, consumer staples, financials, and utilities

Data: Claymore Securities

TOP HOLDINGS/TICKER	SECTOR	PRICE	TOTAL RETURN 2009	TOTAL RETURN 2010*
MICROSOFT/MSFT	●	29.59	61%	-2%
APPLE/AAPL	●	222.25	147	5
GENERAL ELECTRIC/GE	●	18.07	-2	20
ROYAL DUTCH SHELL/RDS.A	●	58.50	21	-1
BP/BP	●	57.69	33	1
JOHNSON & JOHNSON/JNJ	●	65.11	11	2
IBM/IBM	●	127.71	59	-2
AT&T/T	●	26.24	5	-5
CISCO SYSTEMS/CSCO	●	26.15	47	9
CHEVRON/CVX	●	74.98	8	-2

*As of Mar. 19

Data: Bloomberg

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SEYMORE SCHWAST

ACCOUNTANT ANGST

TAXING RELATIONSHIPS

By Amy Feldman and Joan Caplin

As tax time nears, people and their accountants approach each other warily. When clients lay bare their financial secrets—telling their accountants about investment gains, job losses, divorces, and the like—tax pros become more like financial shrinks. That closeness, combined with the general anxieties of tax time, often

brings strong emotions and fraught issues to the surface. Anger? Check. Misplaced boundaries? Check. Fear? Check. Greed? Check.

One sign of accountant-client angst: Plug the words "how to fire your accountant" into Google, and 555,000 hits come up. Procrastinators turn over piles of unsorted documents to their accountants at the last minute—and then get upset when their tax preparers file an extension. They get angry when their accountants nix writeoffs they're convinced they deserve. Meanwhile, the 900,000 to 1.2 million tax preparers—including CPAs, attorneys and others—who fill out 86.6 million tax returns, according to IRS data, vary wildly in terms of the quality of advice, willingness to test the limits of the rules, and the way they interact with clients.

DEDUCTION DEBATES

People often stumble randomly into a relationship with their accountant. Robbie Bell, a 64-year-old Realtor and radio talk-show host in Miami, and her accountant, Gerri Lazarre, 33, have formed a quasi-mother/daughter relationship. They met five years ago at a social event, when Bell admired Lazarre's striking 3-inch heels. Since then, Bell has urged Lazarre to have more fun with her wardrobe, see a doctor about sinus troubles, and do more networking to expand her accounting business, TriMerge Consulting Group. But when it comes to tax time, Bell is not an easy client. She insists on keeping track of receipts by taping little pieces of paper together rather than using a computer program, and she's consistently late in getting information to Lazarre. Though tax season is in full swing for 2009 returns, Bell just last month got her 2008 records to Lazarre. "I love her to death, but she's always a year behind. I hate it. I have to babysit her," says Lazarre. Bell says she dreads their tax-time huddles. "It's like the Inquisition. I feel like I am in the room with the single light bulb dangling over my head."

A different dynamic was at play in the case of an elderly client of John Brandt, a 54-year-old CPA in New Berlin, Wis. The client, 78, had recently installed new energy-efficient windows in a rental property and wanted to get a big deduction for doing so. Unfortunately, Brandt says, the windows were considered a capital improvement for tax purposes and needed to be depreciated over 27½ years. The two had a heated discussion. "She was obstinate that she wanted to take this deduction and that it was unreasonable for the rules not to allow it since [the benefit] would extend beyond her life expectancy," says Brandt, who stood his ground.

"IT'S LIKE THE INQUISITION. I FEEL LIKE I AM IN THE ROOM WITH THE SINGLE LIGHT BULB DANGLING OVER MY HEAD"

DIVORCES AND RETURNS

Many taxpayers go to an accountant who's a family friend or who lives nearby. Sandy Finklin's accountant, for both personal and business filings, is a former college buddy, Crystal Arrington. Finklin, 31, chief executive of Miami Beach-based Divine Purpose Associates, which represents Christian comedians, artists, models, and writers, says Arrington pushes her to be more thrifty and to clip coupons. "She comments on my spending because she helps me with my budget," Finklin says. "I eat out a lot, and she told me I have to cut down on that. I was embarrassed. Initially I felt like she was in my business too much."

More complicated is the case of Kristin Lavieri, a 45-year-old tax preparer at Weinstein & Anastasio, in Hamden, Conn. Lavieri does taxes for her ex-husband and his wife, and her soon-to-be (second) ex-husband. She barters with her first husband, a carpenter, trading tax prep for carpentry work. Lavieri says she chides him when he's late with paperwork, telling him "you've screwed up my schedule." Not surprisingly, there also is angst in the tax relationship with her soon-to-be ex-husband. When she told him what he needed to do to prepare for tax time, she says, he didn't do it. "He wouldn't listen, and now he has a big bill and he's freaking out," she says. Dan Brennan, the soon-to-be-ex, says: "I don't listen. I've learned how to turn her off."

As Apr. 15 approaches, there is one bright spot this year. Many investors have capital losses stockpiled that can offset capital gains. "Even though it's not in their control, CPAs are having a better relationship with their clients now," says Joan Crain, wealth strategist at BNY Mellon Wealth Management in Ft. Lauderdale, Fla. "They're getting pleasant surprises." |BW|

RETIREMENT

SAVINGS PLANS

FINE-TUNING THE 401(k)

By Christopher Farrell

It was a quiet revolution. Section 401(k) of the Internal Revenue Code went into effect on Jan. 1, 1980, with little fanfare. Since then, the 401(k) has evolved into America's largest private-sector employer-sponsored retirement plan, covering some 50 million workers and holding $2.3 trillion in assets, according to the Employee Benefit Research Institute (EBRI).

The 401(k)'s timing was excellent: Its adoption largely coincided with the great 1982-2000 bull market. During that time stocks returned an average of 15.3% a year after inflation—more than double the long-term average of 7%. That fattened 401(k) accounts and led many to believe that pouring money into stocks was a sure way to retire rich.

After two bear markets in less than a decade, that assumption has proved painfully wrong. So now employers and financial services companies are developing strategies to help workers better manage their 401(k)s. The need is obvious. Workers' accounts are dismayingly small. After reaching a peak in 2007, the average 401(k) account balance was down 30% as of December 2008, and stood just below $46,000, calculates EBRI. Balances have likely risen since the market hit bottom in March 2009. Meanwhile, many employers have reduced or even eliminated the company match to employee contributions.

The 401(k) marked a dramatic break with the past. With traditional defined-benefit pension plans, the employer took on all the investment risk and committed to a fixed payout during retirement. It was a costly option for employers. With the 401(k), the employee became the decision-maker and risk-taker. While the ability of workers to control their retirement savings was promoted as the 401(k)'s biggest advantage, it often was the plan's biggest downside. Employees might wait years to sign up, if at all. Even if they did opt in early on, a poorly managed 401(k) could leave them without enough money to retire. "I find having it all up to the individual doesn't make sense," says Alicia Munnell, director of the Center for Retirement Research at Boston College.

Munnell's sentiment is widely shared. Behavioral economists have made a cottage industry of demonstrating how poor most people are at making sound investment decisions. It's all too easy for employees to get swept up in the market's manic moods. And with everyone facing heightened demands at work and at home, there's little time to learn the fine points of modern portfolio theory. Yet investment decisions made at age 30 can determine whether a worker enjoys caviar or corn chips at age 60 or 65.

Although there's talk about getting rid of the 401(k), the greater effort is toward reforming it. Despite its flaws, it is well suited for a mobile workforce with little job security. It's portable and offers faster vesting than defined-benefit plans. Over the past 25 years the median tenure of all workers age 30 or over has stayed at or just below five years. Only a small percentage of private-sector workers stayed at one job long enough to reap the full rewards of defined-benefit plans.



DAVE PLUNKERT

To try and improve investment results in 401(k)s, employers are removing some of the once-vaunted choice and limiting the investment menu. Offering target-date funds that automatically diversify and rebalance a portfolio is one strategy. More companies are increasing participation in 401(k)s by automatically enrolling employees. And financial-services companies are designing low-cost annuity options that could more easily turn 401(k) savings into a guaranteed lifetime income stream at retirement.

Even with those efforts, amassing retirement wealth will remain subject to market whims, to some degree. For better or worse, the revolution looks like it's here to stay. |BW|


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INVESTING

STOCKS

SMALL-CAP SPRINT

By Tara Kalwarski

Little guys do win, at least during a recovery. Small companies are often more nimble—with less burdensome balance sheets and lower fixed costs—than larger rivals, advantages that usually help them bounce back from slumps more quickly. Since the market bottom last March, the Russell 2000, a benchmark for small U.S. stocks, returned 99%, topping the S&P 500's gain of 75%. Lord Abbett senior economist Milton Ezrati thinks the outperformance will persist: His research shows that in seven of the past 10 major recoveries, small caps have beaten large caps for at least three years.

DIGGING FOR DISCOUNTS

Small cap companies may not be the screaming deals they were a year ago. They're trading at about 25 times estimates for the current year's earnings, up from about 22 a year ago. At this level, they're fairly priced, according to T. Rowe Price Small-Cap Value manager Preston Athey: "All measures are right in line with long-term norms, or even slightly cheaper."

And despite the rally, plenty of small companies are undervalued. For instance, nine stocks in Athey's portfolio trade at less than one times book value, while boasting a yield of 3% or more. These include Kite Realty Group Trust, a real estate investment trust whose share price is 78% below its June 2007 high; Gladstone Capital, which invests in debt securities in small- and mid-sized companies and provides loans to private businesses; and transporter Overseas Shipholding Group, a 42 stock that sold above 90 in 2007. "That they pay a dividend tells you management has enough confidence in cash flow that they don't have to hoard every dollar that comes in," says Athey.

Such lesser known companies are not without risk. "Any one of them could have a problem," says Athey. A sensible way to get in on the action is to buy a diversified fund (table).

The 1,700 companies in the Russell 2000 that Wall Street covers are about 10% undervalued, according to Bloomberg's consensus of analyst forecasts. Telecom and health-care companies could rise as much as 15% over the next 12 months, say the analysts, and shares of drug firm ARYx Therapeutics could climb from 1 to 6.50. Telecom General Communication could see its stock, which trades at 6, rise to 10, they say.

The resurgence in mergers and acquisitions could give small caps a boost, says Jane White, a founding principal at Granahan Investment Management, a subadviser to Vanguard's Explorer Fund. White says they've just "started to have buyouts from our portfolio." In the second half of 2009, 39 members of the Russell 2000 were scooped up in mergers or acquisitions. That's more than double the rate in the first half of 2009, according to a study by Ernst & Young.

Ultimately, a continued rally depends on investor enthusiasm. Ernst & Young reported that 32 initial public offerings joined the Russell 2000 in the last half of 2009, up from six a year earlier. That appetite for small companies could bode well. Only three stocks were delisted over the same period, compared with 11 a year earlier. Maria Pinelli, E&Y director of strategic growth markets for the Americas, said on Mar. 10: "The current numbers suggest that all boats are rising with the Russell tide." |BW|

PINT-SIZE PICKS, OUTSIZE GAINS

Morningstar recommends these five small-cap stock funds, which for the most part have outperformed funds that invest in large companies

FUND	TICKER	EXPENSE RATIO	TOTAL RETURN* 1 YEAR	3 YEARS	5 YEARS
Royce Special Equity Investment	RYSEX	1.17%	54%	5%	6%
Vanguard Tax-Managed Small Cap	VTMSX	0.19	67	-2	3
Bogle Small Cap Growth	BOGLX	1.35	81	-9	1
Third Avenue Small-Cap Value	TASCX	1.13	57	-5	1
Bridgeway Small-Cap Value	BRSVX	0.92	66	-9	0

*As of Mar. 19

Data: Morningstar, Bloomberg

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BUSINESS VIEWS

BOOKS By ERIC ROSTON

Engineering the Earth

Jeff Goodell sizes up the silver-bullet technologies that may be needed to combat rising planetary temperatures



Climate scientist Caldeira says geoengineering may buy humanity some time

TODD HIDO

A small group of prominent scientists held three private dinners at a posh San Francisco restaurant in December 2008. Barack Obama had just won the White House promising, among other things, federal action to combat climate change—a complex but well documented problem becoming more urgent by the month. The dinners were called to weigh a possible new weapon against global warming that goes by the clunky name of "geoengineering." ¶ In attendance was Ken Caldeira, a climate modeler with the Carnegie Institution for Science who also happens to explain science better than most of his peers. He articulated a central conundrum for the group: "If you are pushed against the wall in a Senate meeting room and asked what you can do to cool off the planet in a hurry, what do you say?" ¶ That's one question probed in Jeff Goodell's judicious and much needed new book, *How to Cool the Planet*. Just two years after those dinners, geoengineering

BOOKS

has become a flashpoint within the already ferocious climate debate. The British Royal Society has taken a whack at defining the new buzzword: "[T]he deliberate large-scale intervention in the Earth's climate system, in order to moderate global warming."

Diverse motivations are bringing together scientists, and now politicians and entrepreneurs, around this ambitious goal. Some are climate hawks who would outlaw coal-burning today if there were another way to keep the lights on. Some want to ease the impact of climate change on the poor. Others hope to make a buck. Caldeira would like to see carbon emissions driven down to zero and hopes geoengineering might buy us time to reach that target.

A LOT OF KOOKY GEOENGINEERING IDEAS HAVE BUBBLED UP. GOODELL WISELY IGNORES THEM

Another leading thinker on the topic, Lowell Wood, retired as a nuclear weapons expert and threat evaluator from Lawrence Livermore National Laboratory in 2007. He moved to Seattle to join Intellectual Ventures, the big-think technology startup run by former-Microsoft Chief Technology Officer Nathan Myhrvold. Myhrvold looped in Bill Gates. Before you knew it, geoengineering—a cocktail-party curiosity in 2006, when Goodell began this book—was commanding serious attention from public- and private-sector luminaries.

A lot of kooky geoengineering ideas have bubbled up in the popular media. Goodell, a contributing editor at *Rolling Stone* who avoids the over-the-top approach of some of his colleagues, also resists the temptation to write about these, focusing instead on ideas that are beginning to attract research dollars. There's what Wood calls "doping the stratosphere," in which governments release tons of aerosol particles into the sky. They reflect the Sun's light (and explain why big volcanic eruptions tend to cool the climate for a few months or years). A similar notion, "cloud brightening," would pump infinitesimal water droplets into the air to buffer ocean clouds' reflectivity.

The public failure of a startup interested in fertilizing oceans with iron soured many on geoengineering the oceans. The plan was to add iron filings to nutrient-poor parts of the seas, where they might stimulate plankton growth and draw carbon dioxide down into the ocean food web and sediment trap. Then there's Energy Secretary Steven Chu's pet idea of whitening rooftops around the world to reflect solar energy back to space, which has drawn scattered attention.

Which authorities would regulate any of these moves, and how, is anyone's guess, and therefore a looming diplomatic and legal problem—beyond the still-speculative nature of much geoengineering science.



How to Cool the Planet by Jeff Goodell; Houghton Mifflin Harcourt, 262 pp; $26.00

Climate action in Washington has stalled in no small part because of the feared costs to businesses and consumers of rising energy prices. The price per ton of CO_2 pollution might run anywhere from $10 to $30 in a cap-and-trade program like the one President Obama has proposed and the House passed last June. Geoengineering efforts, on the other hand, might cost just 0.7¢ per ton. "This is, by any standard, peanuts," Goodell says. He asks a page later: "Who can resist a cheap fix?"

Well, many environmentalists, that's who. They fear that geoengineering would let polluters off the hook and exacerbate the underlying problem, which is an atmospheric destabilization more dramatic than anything in the recent geological record. Some polluters have embraced geoengineering precisely because of its possible low price. Along the way they've picked up advocates in Stephen J. Dubner and Steven D. Levitt, whose bestseller *SuperFreakonomics* includes a chapter on geoengineering that commits two basic errors: oversimplifying Earth system science and falling in love with the aerosol particle solution.

Dubner and Levitt trumpet a simple answer to climate change in part because they didn't do enough research to understand how little they did. By contrast, Goodell understands there's no approach to the problem that doesn't confront fundamental questions, such as: What is the Earth for? Where does nature end and humanity begin? There is no trace of climate alarmism or political advocacy here. Goodell takes a detailed look at the range of hard choices humanity faces and explores how complicated moral and ethical considerations will dictate our response.

Goodell is also a skilled writer. He splices complicated ideas into pithy turns of phrase: "What kind of person dreams of engineering the entire planet? And can we trust him?" Some of his aperçus are delightful. Atom-bomb scientist Edward Teller "had eyebrows like the wings of a B-52."

Geoengineering, says Goodell, may be an inexpensive way to "cool the planet in a hurry." Or it could be a costly mistake. We don't know yet. In a final chapter called "Human Nature," he writes: "I do believe this is what it comes down to. We can use our imagination and ingenuity to create something beautiful and sustainable, or we can destroy ourselves with stupidity and greed. It is our choice." |BW|

Eric Roston is the author of The Carbon Age: How Life's Core Element Has Become Civilization's Greatest Threat.

TECH & YOU

By RICH JAROSLOVSKY

Should You Put Your Estate in the Cloud?

Software that lets you share important financial data with a spouse or an heir may test your faith in Web 2.0

Just how much should you trust the cloud? It's a question you'll need to ask yourself as software and data slip the confines of your hard drive and take up residence on remote servers thousands of miles away.

I've been using a new program called InformationSAFE (www.infosafe.com) that has forced me to confront the issue in stark terms. The software, which I like a lot, is a simple way to organize your most sensitive personal data—log-ins for bank accounts, insurance policies, even your will—so a spouse, heir, lawyer, or accountant will have all they need in one place should something happen to you. The question is: Where should that one place be?

InformationSAFE comes in two versions. The first you download and install on your PC, and it stores your encrypted data. The other version, which has most of the same features, is an online service—meaning both the software and your data reside on InformationSAFE's servers. You or anyone you authorize can access them on the Web from any computer.

The trade-offs are where you learn a little something about yourself: Information that's stashed locally is under your direct control but vulnerable to fire, flood, or a crashed hard drive if it isn't backed up. As for trusting information to the vast Out There, it's always available, but you must have faith in a small company's security procedures to make sure the bad guys don't grab it.



PETER ARKLE

The desktop edition of InformationSAFE, which runs on PCs and Macs, costs $49.95 from the company's Web site. The Web version costs $4.50 a month, or $49.95 for a year of service. Both employ advanced 256-bit encryption—the type used by the U.S. government. The company provides assurances that data is protected no matter which option you choose.

The software is pretty intuitive. Your information is organized into seven main categories—Personal Info, Financial, Insurance, Legal, Health, Property, and Key Contacts—and multiple subcategories. Choose Bank Accounts under the Financial tab, for instance, and you'll be asked to specify the kind of account. Then you fill out a form that includes fields for financial institution, account number, Web address, user name, password, and the like. You can provide as much or as little information as you choose, and attach files from your computer—anything from a spreadsheet of current investments to a digital copy of your will.

There are a number of ways to allow access to the data. InformationSAFE can print a booklet in Adobe's PDF format or generate a secure link for e-mailing files that expires after 30 days. The online edition allows you to track the documents, and lets you control who else can access the account and what they're allowed to do. It sends you an alert whenever one of your designees logs in.

The decision on desktop vs. cloud could be a generational thing. Older consumers may balk at entrusting sensitive data to something as amorphous as the cloud (not to mention a small startup whose future is uncertain). Younger users may have a vastly different notion of privacy in the era of Facebook and Twitter, to say nothing of Foursquare and Blippy. InformationSAFE's publisher says that about 75% of its users have opted for the desktop version.

Personally, I've decided the cloud is out for now. Besides the higher costs—paying a fee every year, vs. just once—the benefits don't outweigh the risks. I'll make sure my wife knows my password for the desktop version, and I'll print out a report for the safe-deposit box, and maybe for my lawyer. The closest I'll come to the cloud is making sure data is backed up to a remote online service I'm comfortable with. Guess I'm just old-school. |BW|

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FEEDBACK

END OF LIFE

THE COST OF KEEPING ONE MAN ALIVE

I have been a reader for many years and never have I been more touched by an article than by "Lessons of a $618,616 Death" (In Depth, Mar. 15). I am a 28-year-old man and a director of operations for a marketing firm in Chicago. I have never cried in my life in a movie or while reading a book, but something about this article touched me. I think this is the best example I have read to date about needed reforms to our health-care system.

Damien M. Proctor
Director of Operations
Tip-Top Branding
CHICAGO

A quarter million dollars in Other People's Money was paid by thee and me through taxes and insurance premiums to enable one self-centered family to "look down at the Mediterranean from a sunny balcony in southern Spain ... [and take] a carriage ride through Philadelphia's cobbled streets" in a futile bid for immortality. Can there be any better argument for "death panels"?

Paul N. Wenger
WEST HARTFORD, CONN.

WORKPLACE INJURIES

AK STEEL RESPONDS



With regard to "Caution: Stats May Be Slippery" (Mar. 22 & 29), it is *Bloomberg BusinessWeek*'s reporting that may be slippery. You cite an injury from 2005 not recorded with OSHA as evidence of under-reporting. What you failed to report is that our court challenge in that case was a Kentucky Workers' Compensation claim, and it was not an OSHA-recordable injury. State Workers' Compensation programs and OSHA often have different definitions for work-related injuries.

It is preposterous to suggest that we would try to hide an OSHA injury while publicly appealing the workers' compensation claim all the way to the Kentucky Supreme Court. The premise that lower insurance costs would drive underreporting is equally absurd. As a self-insured company, AK Steel annually spends 10 times more for injury prevention than for medical claims resulting from workplace injuries.

You failed to note that our company has third-party audits of our injury logs conducted by a former OSHA area director, and OSHA itself has audited our logs and medical records. In the latter case, two incidents (out of 350 records over five years) were moved from "first aid" to "medical treatment" because prescription medications had been administered.

Finally, your bar chart gives AK Steel a 0.3 injury rate—20% higher than our actual rate of 0.25.

Alan H. McCoy
Vice-President, Government & Public Relations
AK Steel
WEST CHESTER, OHIO

FINANCIAL REFORM

MONKEY SEE, MONKEY DO AT THE BANKS

In "First, Slap Limits on Bank Leverage" (New Business, Mar. 22 & 29), an important point not made is that there is tremendous competition between banks. If one lowers its lending standards, in the short run it becomes more profitable because it takes in lots of new business. Other banks then are forced to follow into the new and more dangerous waters. If they do not, profits lessen, bonuses shrink, employees leave, and the stock price declines. That is why we need government regulation—guidelines for a level playing field and risks understood by all the players.

Ronald E. Miller
Principal
Plaatsdale Investment Advisors
BRANFORD, CONN.

POLITICAL CONTRIBUTIONS

NO LIMITS ON CORPORATE GIFTS

Regarding Jack Bogle's Obamaesque rant on the Supreme Court ("It's Time to Stand Up to the Supreme Court," Outside Shot, Mar. 22 & 29): The way it works, gentlemen, is that shareholders elect directors, who elect officers. Together they decide what is best for the company. If shareholders don't like the results, they either elect different directors or sell their shares.

Norris Goff
LINDEN, VA.

CORRECTIONS & CLARIFICATIONS

In "No Job? Create One" (Personal Business, Mar. 22 & 29), the name of software company Textaurant was misspelled.

Because of an editing error, "The Week in Business" (Mar. 15) misidentified Representative Pete Stark (D-Calif.) as Philip Stark.

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OUTSIDE SHOT

By BOB NARDELLI

Job Creation: Enlist the Experts

There's an untapped resource available to the U.S. that could invigorate the economy —America's best business minds

On a recent trip to China, I was astonished when senior officials of Beijing and Tianjin proudly showed me plans for a financial and commercial city center already under construction. In Tianjin, two hours' drive from the capital, a new skyline—including 18 Chrysler Building-sized structures—is rising. The 102 million-square-foot project is scheduled for completion within 24 months. Add this massive undertaking to multibillion-dollar investments in high-speed rail, smart grids, and green tech, among others, and you have government stimulus that can't help but bolster China's future.

I left China with a sense of urgency over the pace of the U.S. economic recovery. A return to growth is not only a necessary condition for job creation and full economic recovery, it's also the one sure way to sustain America's standard of living and strengthen its competitiveness. But an indebted U.S. can't play the stimulus game Beijing's way.

When I rejoined Cerberus last year and took over the operating responsibility for the roughly 50 companies in our portfolio, I began seeing the economy through the lenses of all these enterprises. From banking to defense to biotech, they generate about $50 billion in annual revenues. Here's another significant number: They support about 100,000 jobs and provide employment security for a vast number of Americans whose incomes were in jeopardy when we acquired their distressed employers.

Over my nearly 40 years in business I've learned many lessons about making investments that create both returns and jobs. The best decisions rest on a foundation of facts, data, and objective analysis of alternatives. Politics, special interests, and ego—in the boardroom or on Capitol Hill—are the enemies of wise choices. And while the Beltway boasts its share of economists, real experience in making business investments has historically been limited in federal government.



The increased friction in today's Washington makes matters even more complicated. The war between our political parties—partisanship simply for partisan ends—is grinding governance to a halt. Moreover, bureaucracy can stifle action once Congress makes a decision. Although the Administration did well to develop a stimulus package and shepherd it quickly through Congress, many feel that money from the American Recovery & Reinvestment Act of February 2009 flowed too slowly. More than 55,000 projects have been initiated, but the ranks of the unemployed grew by more than 2 million from February 2009 to January 2010.

America, however, is rich in one resource that can help: business leaders who excel at making decisions that, despite budgetary constraints, drive growth and job creation. And tapping this resource may not be so difficult.

The government could establish a stimulus strategy team comprised of very high-level former CEOs who are patriots first and have no political agenda. I'm thinking of such top executives as Jack Welch, Lou Gerstner, Andy Grove, Anne Mulcahy, A.G. Lafley, and Larry Bossidy, who created millions of jobs during their careers. I know from interacting with men and women of this caliber that they would be willing to take on the mission of optimizing government stimulus efforts. Working with the Commerce Dept. and other key agencies, they would set guidelines for government programs with budgets, deadlines, and funding recommendations. They would conduct hearings to determine viable goals, while supporting industries with the highest potential yield in job creation, economic gains, and American competitiveness. The emphasis would be on speed, accountability, and results.

This body should have the authority to select, fund, and monitor projects, along with the power to revoke grants to projects that falter and redirect funds to more productive ends. As a check on the commission, the White House and Congress would periodically measure its progress and keep it going or scrap it based on—what else?—its performance. |BW|

Robert Nardelli is CEO of Cerberus Operations & Advisory Co.

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